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# INVESTMENT TRUSTS AND INVESTMENT COMPANIES

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## LETTER FROM THE ACTING CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION

TRANSMITTING, PURSUANT TO LAW, A REPORT ON  
ABUSES AND DEFICIENCIES IN THE ORGANIZATION  
AND OPERATION OF INVESTMENT TRUSTS  
AND INVESTMENT COMPANIES

Chapters I and II



(IN ~~THREE~~ PARTS)

**PART I**

*H 3 - Chap. I-2*

MAY 3, 1939.—Referred to the Committee on Interstate and Foreign  
Commerce and ordered to be printed with illustrations

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UNITED STATES  
GOVERNMENT PRINTING OFFICE  
WASHINGTON : 1940





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## LETTER OF TRANSMITTAL

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SECURITIES AND EXCHANGE COMMISSION,  
*Washington, D. C., August 7, 1939.*

SIR: I have the honor to transmit herewith the first two chapters of Part Three of the Commission's report on the study of investment trusts and investment companies made pursuant to Section 30 of the Public Utility Holding Company Act of 1935.

Part One of this report, dealing with the origins of these organizations, was submitted by the Commission to the Congress under date of June 10, 1938, and has been printed as House Document No. 707, 75th Congress. Part Two, which is a statistical survey of investment trusts and investment companies, was submitted to the Congress on March 10, 1939, and has been printed as House Document No. 70, 76th Congress. A report on investment trusts in Great Britain, the first of a number of supplemental reports, was submitted to the Congress on June 26, 1939, and has been printed as House Document No. 380, 76th Congress.

Part Three deals with the abuses and deficiencies in the organization and operation of investment trusts and investment companies. Chapter I of Part Three discusses the background of investment trusts and investment companies in relation to their abuses and deficiencies. Chapter II sets forth in detail the histories of various investment companies illustrative of the effect of the practices and weaknesses of investment companies upon investors and covers the histories of the following investment trusts and investment companies: Bond and Share Trading Corporation; Burco, Inc.; Central-Illinois Securities Corporation; Chatham Phenix Allied Corporation, later known as Securities Allied Corporation; Continental Securities Corporation; Eastern Utilities Investing Corporation; First Income Trading Corporation; General Investment Corporation, formerly The Public Utility Holding Corporation of America; Insuranshares Corporation of Delaware; Iroquois Share Corporation; Oils & Industries, Inc.; Petroleum Corporation of America; Reynolds Investing Company, Inc.; the group of companies of which control was acquired by Wallace Groves, including Chain & General Equities, Inc., Granger Trading Corporation, Interstate Equities Corporation, and Yosemite Holding Corporation; the investment trusts and companies controlled by Donald P. Kenyon; and investment trusts and investment companies sponsored by C. D. Parker & Co., Inc., of Boston, including Railroad Shares Corporation, Seaboard Utilities Shares Corporation, and Utilities Hydro & Rails Shares Corporation.

The study and report were under the general supervision of Commissioner Robert E. Healy, with Paul P. Gourrich, former technical adviser to the Commission, as director of the study, the late William R. Spratt, Jr., as chief of the study, David Schenker as counsel, and

L. M. C. Smith as associate counsel. Mr. Justice Douglas, former Chairman of the Commission, whose resignation from the Commission was submitted on April 14, 1939, Paul P. Gourrich, former director of the study, whose resignation from the Commission was submitted on March 31, 1939, and William R. Spratt, Jr., former chief of the study, whose death occurred on June 20, 1938, did not participate in the preparation or consideration of Part Three.

Collaborating on the preparation of Part Three, which was under the immediate supervision of David Schenker and L. M. C. Smith, were: E. G. Blunner, Emanuel Publick, H. S. Carver, Harry Heller, C. E. Shreve, Rella Resnick Shwartz, and Alfred Berman, J. P. Devine, L. M. Greene, and Ambrose Selig of the legal section; D. B. Cooper, B. K. DuBois, Ruth M. Fielding, R. C. Gilles, and William Parker of the economic and analysis section; A. J. Breslin, Benjamin Levy, and F. J. Manno of the accounting section; and Morris Bailkin, together with A. L. Traister, D. Virginia Arner, Samuel Blitman, Milton Drexler, Nathan Rubinstein, and Helen K. Steiner of the statistical and editing section. In addition to those public examinations conducted by members of the staff of the investment trust study, certain public examinations in connection with Part Three were conducted by the following members of the Legal Division of the Commission: J. J. Boland, Carlile Bolton-Smith, D. J. Dempsey, M. R. Kroopf, and C. S. Stern. Collaborating on particular portions or aspects of Part Three were the following members of other divisions of the Commission or former members of the staff of the Commission: Frances A. Doolittle, E. J. Fruchtman, J. P. Goode, and W. H. Mack, attorneys; P. R. Friend and Philip Young, analysts; and Karl Aal, C. M. Kollin, W. D. Moran, and M. P. Touhey, accountants.

By direction of the Commission:

ROBERT E. HEALY, *Acting Chairman.*

THE PRESIDENT OF THE SENATE.

THE SPEAKER OF THE HOUSE OF REPRESENTATIVES,

*Washington, D. C.*



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## LIST OF REPORTS SUBMITTED

Part One, Part Two, and Chapters I to VI of Part Three of the over-all report have heretofore been transmitted by the Commission to the Congress. Part One, which was transmitted by the Commission to the 75th Congress on June 10, 1938, consists of a discussion of the nature, classification, and origins of investment trusts and investment companies, and has been printed as House Document No. 707, 75th Congress. Part Two, the transmission of which to the 76th Congress was completed on March 10, 1939, consists of a statistical survey of investment trusts and investment companies and has been ordered printed as House Document No. 70, 76th Congress. Part Three of which the most recent section was transmitted to the 76th Congress on February 8, 1940, deals with the abuses and deficiencies in the organization and operation of investment trusts and investment companies and has been ordered printed as House Document No. 279, 76th Congress.

The Commission has also transmitted to the Congress five supplemental reports, namely: Investment Trusts in Great Britain, transmitted on June 26, 1939, and printed as House Document No. 380, 76th Congress; Investment Counsel, Investment Management, Investment Supervisory and Investment Advisory Services, transmitted on August 17, 1939, and printed as House Document No. 477, 76th Congress; Commingled or Common Trust Funds Administered by Banks and Trust Companies, transmitted on August 30, 1939, and printed as House Document No. 476, 76th Congress; Companies Sponsoring Installment Investment Plans, transmitted on September 22, 1939, and printed as House Document No. 482, 76th Congress; and Fixed and Semifixed Trusts, transmitted on January 15, 1940, and printed as House Document No. 567, 76th Congress.





## PART THREE

### Chapter I

# BACKGROUND OF INVESTMENT COMPANY INDUSTRY IN RELATION TO ABUSES

## I. INTRODUCTION

This part of the over-all report of the Commission deals primarily with the abuses and deficiencies in the organization and operation of the various types of management investment companies,<sup>1</sup> the most important category of investment trusts and investment companies.<sup>2</sup> The abuses and deficiencies which are peculiar to other types of investment companies—fixed and semifixed trusts, installment investment plans and companies issuing face amount installment certificates—will be presented in detail in the respective supplemental reports covering these types. This part of the report is not primarily concerned with the economic and social purposes which the properly organized and honestly and competently managed investment trust or investment company may serve. Thus it does not treat with the useful functions which such organizations may be able to perform for various economic strata of our population, for the capital markets, for industry, for representation of minority stockholders in portfolio corporations or for other sectors of the national economy. These subjects will be dealt with elsewhere in the report.

Before discussing in detail the various abuses, deficiencies, and problems in connection with the organization and activities of management investment companies, certain aspects of the background of investment companies which are relevant to the existence of these malpractices and weaknesses will be described. To that end this chapter will first sketch chronologically certain of the more important features of the general development of investment trusts and invest-

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<sup>1</sup> This category includes management investment companies proper (diversified investment companies which are popularly regarded as investment trusts) and management investment-holding companies (companies which more or less concentrated their investments in particular corporations, often for the purpose of participating in their control). These companies may be further classified as leverage companies (companies with more than one class of security outstanding) and nonleverage companies (companies with only one class of security outstanding). Management investment companies proper may also be either open-end (companies whose shareholders have the right to require the redemption or repurchase of their shares by the company or its representative) or closed-end (companies whose shareholders do not possess the right to compel such repurchases). For a more detailed discussion of the characteristics of the various types of investment companies, see Pt. One, Ch. II, pp. 21-33 (House Doc. No. 707, 75th Congress).

<sup>2</sup> See Pt. Two, Ch. II, Table 17, p. 112 (House Doc. No. 70, 76th Cong.) wherein it is indicated that management investment companies possessed approximately 97% of the assets of the industry at the close of 1929 and 92% at the close of 1936, and constituted about 88% of the total number of investment companies at the end of 1929 and 63% at the end of 1936.

ment companies, will then indicate some of the more important statistical aspects of the industry, and finally will briefly review the extent and nature of the public recognition of the existence of vital problems in connection with the industry.

The examples of individual investment companies presented in this chapter were selected merely because of their size, importance, and pertinence to the development of the entire industry and are not here employed as illustrations of practices involving abuse.

## II. GROWTH OF THE INVESTMENT COMPANY INDUSTRY

### A. Period, 1927-1929

Many of the problems which have confronted the investment company industry had their origin in the years 1920-1929, for it was during that period that the majority of investment companies in operation today were organized,<sup>3</sup> their structures largely determined, and many of their managers placed in power. During that period there were engendered the various deficiencies, inequitable structures, and patterns of improper practices which have prevailed and still persist in many investment companies today and which constitute a continuing threat to the safety and preservation of a large part of the public funds invested in these organizations.

The years ending with 1926 have already been discussed and treated, for the purposes of this report, as the formative period of the investment trust and investment company development in this country.<sup>4</sup> This period was followed by three years in which these organizations achieved substantial importance in our national economy through an unprecedented growth in number and size. The first of these three years constitutes the beginning of the period of the Commission's more detailed study.

#### 1. NATURE OF GROWTH

The same general economic conditions which fostered the creation of practically all of the present types of investment companies by the end of 1926 were not only still present in the three subsequent years but many existed in a more pronounced form. Corporate profits were, roughly, \$7,500,000,000 for the year 1926, declined to \$6,500,000,000 in 1927, and rose to over \$8,700,000,000 for the year 1929. While the index of industrial production rose only 10% and national income somewhat less from 1926 through 1929, both the index of common stock prices and the volume of trading in such stocks on the New York Stock Exchange more than doubled.<sup>5</sup> The accelerated growth of investment companies in these three years thus occurred against the background of a stock market boom which ran ahead of many of the other aspects of industrial and financial development. It was under such extraordinary conditions that the investment company movement reached its peak of expansion.

<sup>3</sup> Pt. Two, Ch. II, Table 16, p. 111 (House Doc. No. 70, 76th Cong.).

<sup>4</sup> For discussion of period prior to 1927 see Pt. One, Ch. III (House Doc. No. 707, 75th Cong.).

<sup>5</sup> For selected statistical data indicating the trend of industrial and financial development in the United States from 1900 to 1929 see Pt. One, Ch. III, Table 1, p. 57 (House Doc. No. 707, 75th Congress).

As might be expected, this stock market boom was exploited in the formation of investment companies and in the distribution of their securities by numerous sponsors who were attracted by the substantial profits obtainable in connection with the launching and operation of such companies. The direct and indirect sources of profit and patronage to the sponsor of an investment company were numerous, continuous, and of great variety. With the absence of a substantial professional class of persons engaged primarily in the business of investment management, individuals with a wide variety of backgrounds entered the field of investment company sponsorship. Brokers, investment bankers, security dealers, investment counselors, salesmen of securities and other merchandise, market traders, commercial bankers, utility financiers, financial promoters, industrialists, professors, economists, lawyers, accountants, and persons engaged primarily in numerous other industries or professions sponsored investment companies and actively promoted public interest in these organizations by the use of general publicity, elaborate advertising, and a variety of other means. The promotion of investment companies was materially accelerated by the fact that no substantial personal investment on the part of the sponsors was requisite for the creation of investment companies, and by the fact that specific statutory restraints and government regulation and supervision of these organizations were virtually absent.

Economic and psychological conditions had already predisposed the investing public to participation in the relatively new investment enterprises in the period before 1927, but apparently their greatest effect came in the succeeding three years. The popularization of the investment company as a medium of investment in a diversified portfolio of securities, particularly common stocks, manifested itself in a substantial increase in the number of individual security holders. Thus, in the two years 1928 and 1929, the total number of known common and preferred stockholders in management investment companies increased practically ninefold from approximately 55,000 to almost 525,000.<sup>6</sup>

By 1929 investment companies were literally being formed at the rate of almost one each business day, with 265 new companies being created in this one year alone.<sup>7</sup> Out of a total of approximately 1,200 investment companies in this country whose dates of organization are known to the Commission, almost 600, or approximately one-half, were organized in the three years 1927 through 1929, and each of these years exceeded the preceding year in the number of new companies organized.<sup>8</sup> Furthermore, the bulk of the sales of their own security issues by investment companies over the entire period of the study took place in these three years, with a concentration in 1929 of almost half of the total sales for the period 1927 to 1936.<sup>9</sup> Thus, yearly sales of these issues increased sharply from almost \$400,000,000

<sup>6</sup> Pt. Two, Ch. V, Table 114, p. 377 (House Doc. No. 70, 76th Cong.). During these same two years the total number of shareholders in fixed and semifixed investment trusts and companies issuing face amount certificates increased from 115,000 in 1927 to 270,000 in 1929. (Id., Table 113, p. 374.)

<sup>7</sup> Pt. Two, Ch. II, Table 16, p. 111 (House Doc. No. 70, 76th Cong.).

<sup>8</sup> Ibid. The same trend is indicated by the tabulation of the number of companies in existence at year-ends. While there were only 161 investment companies in existence at the end of 1926, yet there were 677 in existence at the end of 1929, and the largest number in existence at any year-end was only about 50 more, at the end of 1930. (Ibid.)

<sup>9</sup> Pt. Two, Ch. III, Table 59, p. 186 (House Doc. No. 70, 76th Cong.).

in 1927 to over \$3,000,000,000 in 1929, when it is estimated they represented more than a third of all reported nonrefunding corporate capital issues.<sup>10</sup> From total assets not exceeding \$700,000,000 at the end of 1926, the industry expanded to the extent that its total assets had a market value of about \$7,000,000,000 at the end of 1929, and reached a peak of probably over \$8,000,000,000 before the break in the market in that year.<sup>11</sup> These figures for total assets of the industry in 1929 compare with total assets of below \$2,000,000,000 by the middle of 1932, and not more than \$2,800,000,000 at the end of 1937.<sup>12</sup>

The development in the investment company movement prior to the end of 1929 was heavily concentrated in certain types of companies. New capital in the investment company field from 1927 through 1929 was raised largely by the sale of securities of closed-end companies, that is, by closed-end management investment companies proper and management investment-holding companies.<sup>13</sup> By far the largest number of closed-end management investment companies in existence at any time were organized prior to the end of 1929, and practically all of them were formed prior to the end of 1930.<sup>14</sup> While the three largest open-end investment companies in existence today were organized prior to the end of 1929,<sup>15</sup> the sale of the securities of all open-end management companies up to that time was relatively insignificant as compared with sales by closed-end companies.<sup>16</sup> The sale of the securities of closed-end management investment companies proper and management investment-holding companies declined sharply in 1930 and practically ceased thereafter,<sup>17</sup> although at the end of 1936 these groups still possessed nearly 75% of the assets of the industry.<sup>18</sup>

In the extensive marketing of investment company securities prior to the end of 1929, sponsors were not only engaged in securing additional financing of existing investment companies but often formed new investment companies of a size and with a rapidity which have, to the present, not been equaled. In particular, houses of issue, brokers, and security dealers sponsored and undertook the distribution of the securities of investment company after investment company, these types of sponsorship accounting, on the basis of assets, for over 60% of management investment companies proper in 1929.<sup>19</sup> Accompanying this expansion there was a growing trend toward concentration in the industry, with over 50% of the assets of closed-end management investment companies proper being owned by 10% of the companies in that category.<sup>20</sup>

<sup>10</sup> Ibid.

<sup>11</sup> Pt. One, Ch. III, pp. 35 and 36 (House Doc. No. 707, 75th Cong.), and Pt. Two, Ch. II, pp. 30-2 (House Doc. No. 70, 76th Cong.).

<sup>12</sup> Pt. Two, Ch. II, p. 32 (House Doc. No. 70, 76th Cong.). On the other hand, at the end of 1936 these total assets of the industry exceeded \$4,300,000. (Ibid.)

<sup>13</sup> Pt. Two, Ch. III, Table 60, p. 190 (House Doc. No. 70, 76th Cong.).

<sup>14</sup> Pt. One, Appendix A (House Doc. No. 707, 75th Cong.).

<sup>15</sup> These companies are Massachusetts Investors Trust, Incorporated Investors and State Street Investment Corporation. (Pt. Two, Ch. II, Table 6, p. 56 (House Doc. No. 70, 76th Cong.), and Pt. One, Appendix A [House Doc. No. 707, 75th Cong.].)

<sup>16</sup> Pt. Two, Ch. III, Table 60, p. 190 (House Doc. No. 70, 76th Cong.).

<sup>17</sup> Ibid.

<sup>18</sup> Pt. Two, Ch. II, Table 17, p. 112 (House Doc. No. 70, 76th Cong.).

<sup>19</sup> Pt. Two, Ch. II, Table 25, p. 124 (House Doc. No. 70, 76th Cong.).

<sup>20</sup> Id., Table 23, p. 122.

The increase of capital in existing investment companies, as well as the rapid formation of new subsidiary or affiliated companies, is illustrated by the activities of Central States Electric Corporation. This corporation, which was controlled since 1922 by Harrison Williams through his common stock holdings,<sup>21</sup> had expanded, through appreciation of its holdings and the raising of new capital, from a \$6,000,000 company at its organization in 1912<sup>22</sup> to a company with approximately \$50,000,000 of gross assets at the end of 1927.<sup>23</sup> Yet in the succeeding year and three-quarters, from January 1, 1928, through September 1929, this company individually, jointly with, and through others brought about the sale of approximately half a billion dollars of security issues of its own and of affiliated companies. Of these securities, approximately half was sold directly to the public and the other half was sold to companies affiliated with the various sponsors.<sup>24</sup> These affiliated companies themselves had substantial amounts of securities outstanding in the hands of the public. This distribution involved, among other things, the successive formation of four new investment companies, with only a few months intervening between each new organization, and each new company was larger than the preceding one. American Cities Power and Light Corporation, the first new company, was created in October 1928 with approximately \$40,000,000 of assets shortly after organization;<sup>25</sup> Electric Shareholdings Corporation was formed in March 1929 with nearly \$49,000,000 of assets at organization;<sup>26</sup> and Shenandoah Corporation, upon its organization in July 1929, raised \$102,500,000<sup>27</sup> by an issue which was reported to have been oversubscribed seven times.<sup>28</sup> Additional amounts of capital stock were issued by Shenandoah Corporation in early September 1929,<sup>29</sup> in connection with its sponsorship and acquisition of control of Blue Ridge Corporation, which was formed in August 1929 with approximately \$142,000,000 of capital.<sup>30</sup> Since Central States Electric Corporation and its affiliated companies held 26% of the common stock of the North American Company as of September 30, 1929, Mr. Williams was able, as controlling stockholder of Central States Electric Corporation, to exercise a substantial influence in a public utility holding company system whose securities at market were then worth almost a billion dollars.<sup>31</sup> The latter two companies of the system, Shenandoah Corporation and Blue Ridge Corporation, were formed not only under the direct or indirect sponsorship of Harrison Williams through Central States

<sup>21</sup> Public Examination, Central States Electric Corporation, at 12393-6 and Commission's Exhibit No. 1205.

<sup>22</sup> Central States Electric Corporation's initial and sole asset upon organization in 1912 was a block of 44,036 shares of Cleveland Electric Illuminating Company, purchased at a cost of \$5,724,000. (Id., at 12260-6.) The stock of Cleveland Electric Illuminating Company was its principal asset until 1922. (Id., at 12289-90, 13310-11.)

<sup>23</sup> Op. cit. supra, note 21, Commission's Exhibit No. 1206.

<sup>24</sup> Id., Commission's Exhibit No. 1233.

<sup>25</sup> Id., at 12404-5 and Commission's Exhibit No. 1233.

<sup>26</sup> Ibid.

<sup>27</sup> Id., at 12405.

<sup>28</sup> Id., at 13443.

<sup>29</sup> Id., at 12866-7 and Commission's Exhibit No. 1233.

<sup>30</sup> Ibid.

<sup>31</sup> Id., Respondent's Exhibit A.

Electric Corporation, but also of Goldman, Sachs & Co.,<sup>32</sup> a brokerage and investment banking firm of New York City, through a newly formed investment company, The Goldman Sachs Trading Corporation.<sup>33</sup>

The Goldman Sachs Trading Corporation, which marked the entrance of Goldman, Sachs & Co. into the investment company field, had an equally extraordinary expansion in scarcely more than a year from its incorporation on December 4, 1928, during all of which time it was under the complete control of its sponsor.<sup>34</sup> Goldman, Sachs & Co., the sponsor, purchased the entire initial issue of 1,000,000 shares of the capital stock of The Goldman Sachs Trading Corporation at \$100 per share for \$100,000,000,<sup>35</sup> redistributing 90% of these shares through a selling group to the public at \$104 per share for a total of \$93,600,000, and retaining 10% of these shares as an investment of the firm.<sup>36</sup> During the following two months the investment company sold 125,000 additional shares of its own stock (12½% of the then outstanding stock) on the New York Curb Exchange for aggregate proceeds of approximately \$15,800,000.<sup>37</sup> By February 21, 1929, The Goldman Sachs Trading Corporation had consummated a merger with Financial and Industrial Securities Corporation, another investment company,<sup>38</sup> the net assets of the new company being valued for the purposes of the merger at \$235,000,000.<sup>39</sup> By July of the same year The Goldman Sachs Trading Corporation had joined in the sponsorship of Shenandoah Corporation, referred to above, and had made in connection therewith an exchange of its own capital stock for the stock of Shenandoah Corporation, thereby adding \$25,000,000 to its outstanding capitalization.<sup>40</sup> In addition to acting as a joint sponsor of and being a substantial stockholder in Shenandoah Corporation, which in turn in August 1929 had sponsored Blue Ridge Corporation,<sup>41</sup> The Goldman Sachs Trading Corporation had increased its own assets during the summer of 1929 by the issuance of some \$71,400,000 of additional capital stock. This additional capital stock was exchanged for 81% of the outstanding capital stock of the American Company,<sup>42</sup> a holding company owning over 99% of the common stock of the American Trust Company of

<sup>32</sup> For formation of Shenandoah Corporation, see *id.*, at 13189-91 and 13413-15; for formation of Blue Ridge Corporation, see *id.*, at 13590-3.

<sup>33</sup> *Op. cit. supra*, note 21, at 13410-12.

<sup>34</sup> On the day of incorporation, The Goldman Sachs Trading Corporation entered into a management contract with its sponsor, Goldman, Sachs & Co., whereby complete supervision of its affairs was vested in the latter. (Public Examination, The Goldman Sachs Trading Corporation, at 15863-4, and Commission's Exhibit No. 1654.) On April 17, 1933, control of The Goldman Sachs Trading Corporation passed to Atlas Corporation. (Public Examination, Atlas Corporation, Commission's Exhibit No. 2001 at pp. 321-2.)

<sup>35</sup> Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibit No. 1655.

<sup>36</sup> *Id.*, at 15866 and Commission's Exhibit No. 1659.

<sup>37</sup> *Id.*, at 15917.

<sup>38</sup> Financial and Industrial Securities Corporation was formed in December 1925 by individuals closely identified with the Manufacturers Trust Company of New York and the law firm of Jonas and Neuberger. (Public Examination, Financial and Industrial Securities Corporation, at 18895-6 and Commission's Exhibits Nos. 2098 and 3003.)

<sup>39</sup> *Op. cit. supra*, note 35, Commission's Exhibit No. 1681.

<sup>40</sup> *Id.*, at 15869.

<sup>41</sup> See discussion *supra*.

<sup>42</sup> *Op. cit. supra*, note 35, at 15869 and Commission's Exhibit No. 1736. For total American Company stock outstanding, see *id.*, Commission's Exhibit No. 1766.

San Francisco, California.<sup>43</sup> The total gross capital thus raised or obtained by The Goldman Sachs Trading Corporation from the time of its organization in December 1928 through the summer of 1929 aggregated approximately \$330,000,000.<sup>44</sup> Of this amount, about \$115,800,000 was raised by the issuance of its securities for cash and the balance was secured through exchanges of securities and mergers.<sup>45</sup> Through the sponsorship of The Goldman Sachs Trading Corporation and the subsequent participation of that company in the sponsorship of other investment companies, the brokerage and investment banking firm of Goldman, Sachs & Co. ultimately obtained sole or joint control of capital funds of investment companies aggregating nearly one-half billion dollars.<sup>46</sup> This sponsor firm achieved a position of influence in the subsidiary companies of The Goldman Sachs Trading Corporation and in companies in which that investment company constituted one of the largest stockholders, with total resources, including those of the foregoing investment companies of approximately \$1,700,000,000 at the end of 1929.<sup>47</sup>

An even greater expansion in a relatively short period of time was experienced by the group of investment trusts and investment companies which was commonly known as the United Founders Corporation group. At the end of November 1927 this group consisted of three investment companies, headed by American Founders Trust, with aggregate paid-in resources of about \$77,869,000, including intercompany holdings of \$6,817,000.<sup>48</sup> Yet by the end of 1929 the immediate group<sup>49</sup> had grown to 13 companies, headed by United Founders Corporation, with paid-in resources of \$686,165,000, including intercompany holdings of \$182,338,000.<sup>50</sup> Substantially all of this capital was raised in the two years 1928 and 1929.<sup>51</sup> By the end of 1929 the United Founders Corporation group represented one of the largest aggregations of investment company capital falling within the scope of the Commission's study. The market value of the outstanding securities of the principal corporations in the immediate group, exclusive of many affiliated companies, at that time exceeded \$1,000,000,000, of which about \$717,000,000 was held by the public and about \$320,000,000 by the companies in the group.<sup>52</sup>

In early January 1929 J. P. Morgan and Co., with Bonbright & Co., Inc. and Drexel & Co., sponsored The United Corporation,<sup>53</sup>

<sup>43</sup> Op. cit. supra, note 35, at 16059.

<sup>44</sup> Id., at 15870.

<sup>45</sup> See discussion supra.

<sup>46</sup> Op. cit. supra, note 35, at 15876.

<sup>47</sup> Id., Commission's Exhibit No. 1671.

<sup>48</sup> Public Examination, American General Corporation et al., Commission's Exhibit No. 3424-A-1.

<sup>49</sup> The Founders group also had a number of affiliated companies. (Id., Commission's Exhibit No. 3400 at p. 4.)

<sup>50</sup> Op. cit. supra, note 48, Commission's Exhibit No. 3424-C-1. The intercompany holdings are valued at average issue price for each class of securities. (Ibid.) The gross public contribution was somewhat more than the figures might indicate by reason of profits realized upon distribution to the public of issues originally allotted to companies within the group. However, the effect of these profits on the net capital raised was diminished by reason of the return of capital to the public through reacquisitions of securities included in the intercompany holdings at a cost in excess of average issue prices.

<sup>51</sup> Op. cit. supra, note 48, Commission's Exhibits Nos. 3424-A-1 and 3424-C-1.

<sup>52</sup> Pt. One, Ch. III, pp. 97-101 (House Doc. No. 707, 75th Cong.).

<sup>53</sup> Report of the Federal Trade Commission upon Utility Corporations, pursuant to S. Res. 83, 70th Congress, 1st Session, Doc. 92, Pt. 52, p. 492.



which eventually became a vast public utility investment-holding company. By the close of that year The United Corporation had on its books almost \$325,000,000 of assets, consisting principally of securities.<sup>54</sup> These assets had been acquired by the investment company either through a series of exchanges of its own security issues with its sponsors, other companies, and members of the public for securities which became the portfolio of The United Corporation, or had been purchased for cash raised by The United Corporation from the sale of its security issues to its sponsors and from the exercise of option warrants and stock subscriptions by the public.<sup>55</sup>

A number of the larger investment banking and brokerage firms in New York, as well as many of the smaller firms in that city, where the industry was substantially localized,<sup>56</sup> were connected either with the financing or the sponsorship and management of investment companies. Not infrequently an investment banking firm which had already sponsored one investment company took advantage of the conditions favorable to the creation of these organizations and sponsored and sold the securities of a new investment company. Thus, in October 1928, United States & International Securities Corporation was formed under the sponsorship of Dillon, Read & Co. with a capital of approximately \$60,000,000 as a subsidiary of United States & Foreign Securities Corporation.<sup>57</sup> an investment company which had been formed<sup>58</sup> by the same sponsor in 1924 with approximately \$30,000,000 of capital upon its organization.<sup>59</sup> So, too, the investment banking and brokerage firm of J. & W. Seligman & Co., which, in January 1929 had organized the \$50,000,000 Tri-Continental Corporation, sold its securities,<sup>60</sup> and thereafter managed that company, in August of the same year sponsored and distributed the securities of Tri-Continental Allied Company, Inc., another \$50,000,000 investment company.<sup>61</sup>

Another large New York banking house to organize and sponsor an investment company under its own management was Lehman Broth-

<sup>54</sup> Based upon cost or declared value, the market value at the time being slightly greater, as disclosed by The United Corporation's balance sheet as of December 31, 1929. (Id., at 518.)

<sup>55</sup> For these transactions in detail see Report of the House Committee on Interstate and Foreign Commerce on Relation of Holding Companies to Operating Companies in Power and Gas Affecting Control, 73rd Congress, House Report No. 827, Pt. 5, Exhibit K (facing p. 794).

<sup>56</sup> Pt. Two, Ch. II, Table 27, p. 127 (House Doc. No. 70, 76th Congress). The localization of the industry is emphasized by the fact that three-quarters of the total assets of management investment companies proper at the year-ends 1928 and 1929 were held in greater New York. The extent of the concentration is also reflected by the fact that over one-half of the total number of management investment companies proper in the years 1928 and 1929 were located in greater New York. (Ibid.)

<sup>57</sup> Public Examination, United States & Foreign Securities Corporation et al., at 11734, 11736-8, and reply to the Commission's questionnaire for United States & International Securities Corporation, Pt. I (Items 1 and 5, and Exhibits B-1 to B-6).

<sup>58</sup> Reply to the Commission's questionnaire for United States & Foreign Securities Corporation, Pt. I (Item 5).

<sup>59</sup> Id. (Items 1 and 5 and Exhibits B-1 to B-5) and Public Examination, United States & Foreign Securities Corporation et al., at 11716, 11720-1.

<sup>60</sup> Public Examination, Tri-Continental Corporation et al., at 18518; and summary statement supplied the Commission for Tri-Continental Corporation and Tri-Continental Allied Company, Inc. (Item I).

<sup>61</sup> Summary statement supplied the Commission for Tri-Continental Corporation and Tri-Continental Allied Company, Inc. (Item II), and Public Examination, Tri-Continental Corporation et al., at 18528-30.

ers, which distributed the securities of The Lehman Corporation with \$100,000,000 of paid-in capital upon organization in September 1929<sup>62</sup> after the firm had already been associated with several other investment company undertakings.<sup>63</sup> These other investment company connections included a participation with Lazard Frères, investment bankers, in organizing General American Investors Company, Inc., and Second General American Investors Company, Inc.,<sup>64</sup> and in offering the security issues of these investment companies, aggregating over \$30,000,000, from January 1927 to September 1929;<sup>65</sup> a participation in the \$70,000,000 offering of the securities of Selected Industries, Inc., in December 1928 and January 1929;<sup>66</sup> a participation in the offering of a \$6,000,000 debenture issue of New York & Foreign Investing Corporation in December 1928;<sup>67</sup> and a participation in the \$25,000,000 security offering of American International Corporation in January 1929.<sup>68</sup> Somewhat similarly, Hayden, Stone & Co., an investment banking and brokerage house, joined with Hallgarten & Co. in the organization<sup>69</sup> and offering of \$23,000,000 of securities of Haygart Corporation, an investment company, in November 1928 and March and April 1929;<sup>70</sup> acted in May 1929 as syndicate manager in underwriting an offering of almost \$10,000,000 of the securities of The Adams Express Company to its stockholders<sup>71</sup> with the management of which it was closely affiliated;<sup>72</sup> and participated substantially in the sale of the \$16,000,000 security offering of Sterling Securities Corporation in September 1929.<sup>73</sup>

The rapid organization and expansion of investment companies, although concentrated in New York City, were simultaneously taking place in various other parts of the country. In Chicago, for example, Field, Glore & Company and its predecessors, investment bankers, actively sponsored and distributed the securities of seven investment companies within a period of less than a year and three-quarters. In January 1928 this firm participated with Bonbright & Co. as the Amer-

<sup>62</sup> Public Examination, The Lehman Corporation, at 5314-15.

<sup>63</sup> *Id.*, at 5335-8.

<sup>64</sup> *Ibid.* and Public Examination, General American Investors Company, Inc., at 5714-15.

<sup>65</sup> Public Examination, General American Investors Company, Inc., at 5717, 5737, 5738, 5742, 5747, and 5771. See also *op. cit. supra*, note 62, at 5335-6 and reply to the Commission's questionnaire for General American Investors Company, Inc., Pt. I (Exhibits III and XV) and Pt. V (Item 41 and Exhibit I).

<sup>66</sup> Reply to the Commission's questionnaire for Selected Industries, Inc., Pt. I (Exhibits I-6-A and I-6-B) and Pt. V (Items 35 and 41). Selected Industries, Inc. was incorporated in December 1928 with Lehman Brothers as one of its sponsors. (*Id.*, Pt. I [Items 1 and 5].)

<sup>67</sup> Reply to the Commission's questionnaire for New York & Foreign Investing Corporation, Pt. I (Item 6-M) and Pt. V (Item 41). New York & Foreign Investing Corporation was incorporated in June 1928 with Lehman Brothers as one of its sponsors. (*Id.*, Pt. I [Items 1 and 5].)

<sup>68</sup> Reply to the Commission's questionnaire for American International Corporation, Pt. I (Exhibit 15) and Pt. V (Item 41 and Exhibit 22).

<sup>69</sup> Public Examination, The Adams Express Company, at 6891-3.

<sup>70</sup> *Id.*, Commission's Exhibits Nos. 637, 639, 640, and 641 and reply to the Commission's questionnaire for Haygart Corporation, Pt. I (Exhibits 2, 3, 4, and 6) and Pt. V (Items 35, 40, 41, and 45).

<sup>71</sup> *Op. cit. supra*, note 69, at 6863 and reply to the Commission's questionnaire for The Adams Express Company, Pt. I (Exhibits 3 and 18).

<sup>72</sup> *Id.*, at 6854.

<sup>73</sup> Public Examination, Sterling Securities Corporation, Commission's Exhibit No. 1513.

ican organizers of Italian Superpower Corporation<sup>74</sup> in an original public offering of a \$20,250,000 debenture issue and a subsequent offering of \$4,000,000 of debentures in July 1929.<sup>75</sup> At the end of November 1928 this sponsor, then known as Glore & Co.,<sup>76</sup> participated with others<sup>77</sup> in the creation of Aviation Securities Corporation,<sup>78</sup> by distributing over \$3,000,000 of its common stock.<sup>79</sup> Within two months thereafter, in January 1929,<sup>80</sup> this sponsor firm also participated with others<sup>81</sup> in organizing Tobacco and Allied Stocks, Inc., and in raising the \$3,000,000 paid-in capital<sup>82</sup> with which that investment company commenced operations. In the following month, February 1929, this same sponsor firm organized and sold the securities of The Chicago Corporation<sup>83</sup> with some \$59,000,000 of capital at its inception.<sup>84</sup> At the beginning of August 1929 another investment company, F. G. Trading Corporation, was organized,<sup>85</sup> and its paid-in capital of over \$4,500,000<sup>86</sup> was raised by Field, Glore & Company, which was its sole sponsor. In the same month, under a plan of recapitalization of Chicago Investors' Corporation,<sup>87</sup> Field, Glore & Company made a public offering<sup>88</sup> of that company's preference and common stocks which netted the investment company \$9,975,000.<sup>89</sup> Finally, in the next month, September 1929,<sup>90</sup> Field, Glore & Company participated with the Continental Illinois Company,<sup>91</sup> the security affiliate of Continental Illinois National Bank and Trust Company, in the organization and sale of the securities of Continental Chicago Corporation with a capital of almost \$64,000,000.<sup>92</sup>

<sup>74</sup> Reply to the Commission's questionnaire for Italian Superpower Corporation, Pt. I (Items 1 and 5). Field, Glore & Company was successor to Marshall Field, Glore, Ward & Co., Inc., the original sponsor. (Id., Pt. I [Item 5].)

<sup>75</sup> Reply to the Commission's questionnaire for Italian Superpower Corporation, Pt. I (Exhibits F-1 and F-2) and Pt. V (Item 41).

<sup>76</sup> Reply to the Commission's questionnaire for Aviation Securities Corporation, Pt. I (Item 5).

<sup>77</sup> This group included Mander Investment Co. and James C. Willson & Co., security dealers, both of Chicago. (Reply to the Commission's questionnaire for Aviation Securities Corporation, Pt. I.)

<sup>78</sup> Organized November 26, 1928. (Reply to the Commission's questionnaire for Aviation Securities Corporation, Pt. I [Item 1].)

<sup>79</sup> Reply to the Commission's questionnaire for Aviation Securities Corporation, Pt. I (Exhibit 6) and Pt. II.

<sup>80</sup> Reply to the Commission's questionnaire for Tobacco and Allied Stocks, Inc., Pt. I (Item 1).

<sup>81</sup> Also included as sponsors were International Acceptance Bank, Inc. (a commercial bank), Colvin & Company, Edward B. Smith & Company (investment bankers), and Joseph F. and Howard S. Cullman (tobacco merchants). (Id., Pt. I [Item 5].)

<sup>82</sup> Op. cit. supra, note 80, Pt. I (Exhibits G, I, and O).

<sup>83</sup> Reply to the Commission's questionnaire for The Chicago Corporation, Pt. I (Item 2-b and Exhibit 1-f).

<sup>84</sup> Id., Pt. I (Exhibit 1-f) and Pt. V (Item 41, b, iii).

<sup>85</sup> Reply to the Commission's questionnaire for F. G. Trading Corporation, Pt. I (Items 1 and 5).

<sup>86</sup> Id., Pt. V (Item 42).

<sup>87</sup> Op. cit. supra, note 83, Pt. I (Exhibit 1-e) and Pt. V (Item 40-d).

<sup>88</sup> Public Examination, The Chicago Corporation, at 9661.

<sup>89</sup> Op. cit. supra, note 83, Pt. V (Item 40). Previously, in November 1928, Chicago Investors' Corporation had been recapitalized under a plan by which it acquired all the assets, aggregating approximately \$3,000,000, of Northern Investment Company, successors to Glore Investment Company. (Ibid. and op. cit. supra, note 88, at 9664.)

<sup>90</sup> Op. cit. supra, note 83, Pt. I (Item 1-d).

<sup>91</sup> Id., Pt. I (Item 5).

<sup>92</sup> Id., Pt. I and Pt. V (Item 41, b, iii).

In Detroit, the investment banking firm of E. E. MacCrone & Co. provided the genesis of two distinct investment company movements. Jonathan B. Lovelace, a member of that firm, participated with others in sponsoring four investment companies by the process of bringing together a group of well-known business men in the different localities where each investment company was organized. Thus, The Investment Company of America<sup>93</sup> was incorporated in Detroit, Michigan, in October 1926, with capital raised at organization and shortly thereafter of more than \$13,000,000;<sup>94</sup> two more companies, Pacific Investing Corporation<sup>95</sup> in April 1927 and American Capital Corporation<sup>96</sup> in May 1928 were started in Los Angeles, California, with capital raised at the end of 1928 of<sup>97</sup> over \$13,400,000 and \$15,000,000,<sup>98</sup> respectively; and finally, Southern Bond & Share Corporation<sup>99</sup> was formed in Birmingham, Alabama, in July 1928 with capital<sup>100</sup> of more than \$3,000,000. In addition, Fred Y. Presley, originally associated with E. E. MacCrone & Co., severed his connection with that firm in order to carry out his investment company plans<sup>101</sup> and enlisted the support of the Guardian Detroit Company of Detroit, Michigan,<sup>102</sup> and affiliated commercial banks.<sup>103</sup> From the middle of 1927 to August 1929, in conjunction with these banking interests, he sponsored four investment companies successively,<sup>104</sup> known as the National Investors group, with net capital<sup>105</sup> of some \$48,000,000. A projected fifth company was abandoned late in 1929 by reason of the unfavorable market developments.<sup>106</sup>

## 2. STIMULATING FACTORS

The extensive distribution of investment company securities in this period of highly inflated and often artificial market prices is a significant chapter in the history of the investment company movement. The growing public interest in common stock investments was seized upon by an increasing number of agencies for the distribution of investment company securities. This trend facilitated the growth of the investment company movement and hence the opportunities for

<sup>93</sup> Reply to the Commission's questionnaire for The Investment Company of America, Pt. I (Items I-d and 5).

<sup>94</sup> *Id.*, Pt. II and Pt. V (Item 41).

<sup>95</sup> Reply to the Commission's questionnaire for Pacific Southern Investors, Inc., Pt. I (Items 1 and 5).

<sup>96</sup> Reply to the Commission's questionnaire for American Capital Corporation, Pt. I (Items 1 and 5).

<sup>97</sup> *Op. cit. supra*, note 95, Pt. II and Pt. V (Supplemental Items 41 and 42).

<sup>98</sup> *Op. cit. supra*, note 96, Pt. II and Pt. V (Items 41 and 42).

<sup>99</sup> *Op. cit. supra*, note 95, Pt. I (Items 1 and 5).

<sup>100</sup> *Id.*, Pt. II and Pt. V (Supplemental Item 41).

<sup>101</sup> Public Examination, National Investors Corporation, at 4240-6.

<sup>102</sup> *Id.*, at 4246-7.

<sup>103</sup> *Id.*, at 4252-4.

<sup>104</sup> Replies to the Commission's questionnaire for National Investors Corporation, Second National Investors Corporation, Third National Investors Corporation, and Fourth National Investors Corporation, Pt. I (Item 5). See also Pt. One, Ch. III, pp. 112-113 (House Doc. No. 707, 75th Cong.).

<sup>105</sup> Replies to Commission's questionnaire for Second National Investors Corporation, Third National Investors Corporation and Fourth National Investors Corporation, Pt. V (Items 41 and 43-b) and for National Investors Corporation, Pt. III and Pt. V (Items 41 and 43-b). This figure excludes the cross holdings in the group. (*Ibid.*)

<sup>106</sup> *Op. cit. supra*, note 101, at 4325-8.

sponsors to profit from the organization and operation of such companies. These sponsors in turn aroused additional public interest by promotional literature and other means, thus creating a self-energizing circle. As the investment company movement gathered increasing momentum in the three years preceding the stock market collapse in the fall of 1929, several additional factors stimulated this trend and were significant in helping to create unprecedented profits, both realized and unrealized, in a relatively short time.

#### a. Leverage

The investment company was easily adaptable to the issuance of almost any type or class of security which might appeal to the prevailing public whim. This was particularly true of the junior securities of investment companies with more than one class of security outstanding, because of the favorable action of leverage in times of rising securities prices.<sup>107</sup> In such times the increase in the asset value applicable to the outstanding junior security issues is proportionately greater than the increase in the total value of all the assets of the investment company, reflecting what is often called the "leverage" of the junior securities. Conversely, in times of declining security prices the decrease in asset value of the junior securities in a company with more than one class of security outstanding is proportionately greater than the decrease in its total assets. Leverage results because the junior securities receive the benefit of all of any increase in income and assets once the claims of the senior securities, which are limited and fixed in amount, are satisfied. The junior securities likewise sustain all of any decrease in income and assets before the senior securities.

Leverage in an investment company was often secured in a number of other ways: By having leverage in portfolio securities of the investment company; by superimposing upon the leverage of the portfolio securities the leverage obtainable by the issuance by the investment company of securities and obligations senior to common stock within the capital structure of the investment company itself;<sup>108</sup> and by the process of superimposing or pyramiding one leverage investment company upon another leverage investment company. Thus, with the maximum use of various kinds of leverage, a small rise in the market price of a common stock held in the portfolio of an investment company at the base of a pyramided leverage system might be reflected many times in the asset value, and hence in the market price, of the common stock of the top company in the investment-company system.<sup>109</sup>

An illustration of the operation of leverage is found in the increase in the asset value of the common stock of United States & Foreign Securities Corporation. This investment company<sup>110</sup> was organized

<sup>107</sup> For a brief explanation of leverage and its operation see Pt. One, Ch. II, p. 28 (House Doc. No. 707, 75th Cong.). For the comparative market movements of leverage and nonleverage issues see Pt. Two, Ch. IV, pp. 312-14 (House Doc. No. 70, 76th Cong.).

<sup>108</sup> It is this type of leverage which is usually referred to in characterizing investment companies as "leverage investment companies." (See Pt. One, Ch. II, p. 28 (House Doc. No. 707, 75th Cong.).)

<sup>109</sup> E. g., Central States Electric Corporation; see *op. cit. supra*, note 21, at 12517-18 and Commission's Exhibit No. 1208.

<sup>110</sup> *Op. cit. supra*, note 58, Pt. I (Item 1).

in October 1924 with a public subscription of \$25,000,000, representing 250,000 shares of first preferred stock (entitled in liquidation to \$100 per share) and 250,000 shares of common stock.<sup>111</sup> By the payment of \$5,100,000 the sponsors secured 50,000 shares of second preferred stock (entitled on liquidation to \$100 per share) and 750,000 shares of common stock.<sup>112</sup> As a result of the deduction of underwriting and selling commissions and organization expenses,<sup>113</sup> the assets of the investment company at its inception were not quite sufficient to meet the prior claims of \$30,000,000 applicable to the first and second preferred stocks upon liquidation. Thus, at the time, the common stock had no asset value<sup>114</sup> and possessed marked leverage possibilities of its own, in addition to the leverage provided by leverage common stocks in the portfolio.<sup>115</sup> About four years later, on September 30, 1928, there had accrued to the common stock about \$23,000,000 of net asset value,<sup>116</sup> being practically all of the appreciation in the total assets of the investment company, while the market value of the common stock was even greater by some 25%.<sup>117</sup> Thus the asset value of this common stock held predominantly by the directors of the investment company and members of the sponsor firm<sup>118</sup> by this time showed an appreciation equal to approximately three-quarters of the original capital investment in the company.<sup>119</sup> On the basis of market value, the sponsors, still retaining 75% of the company's voting power, had profits of some 450% over their original total investment, while the public profited only some 28% over its total contribution.

### b. Trading Activities

Another important stimulant to the investment company movement in the three years 1927-1929 was the extensive trading activity in

<sup>111</sup> This stock was sold upon a part-paid basis in units of one share of preferred and one share of common stock at \$100 for each unit. (Public Examination, United States & Foreign Securities Corporation et al., at 11720-1.)

<sup>112</sup> Public Examination, United States & Foreign Securities Corporation et al., at 11720-1; see also op. cit. supra, note 58, Pt. I, and Hearings before the Senate Committee on Banking and Currency, pursuant to S. Res. 84, 72d Cong., and S. Res. 56 and S. Res. 97, 73rd Cong., Pt. 4, pp. 1641-2.

<sup>113</sup> The underwriting commissions amounted to \$1,000,000. (Op. cit. supra, note 58, Pt. I [Exhibit B-1].)

<sup>114</sup> Public Examination, United States & Foreign Securities Corporation et al., at 11721-4.

<sup>115</sup> Op. cit. supra, note 58, Pt. II.

<sup>116</sup> Id., Pt. IV (Item 28, Table 7A).

<sup>117</sup> Ibid.

<sup>118</sup> See discussion supra and op. cit. supra, note 114, at 11721 and 11739.

<sup>119</sup> Additional leverage for the common stock of this investment company was obtained in the following month, October 1928, by the organization of a subsidiary investment company, United States & International Securities Corporation. (Reply to the Commission's questionnaire for United States & International Securities Corporation, Pt. I [Items 1 and 5], and op. cit. supra, note 114, at 11734-6.) Substantially the same leverage pattern was followed as was originally possessed by the first investment company. The public subscribed \$50,000,000 for the first preferred stock and one-fifth of the common stock with certain additional rights, in part-paid units, while the parent investment company—instead of the sponsor firm as before—acquired four-fifths of the common stock (which was in effect a bonus) with its subscription to a \$10,000,000 second preferred issue. (Op. cit. supra, note 114, at 11737.) A \$2,000,000 underwriting commission, together with organization expenses, again served to prevent the common stock from having any asset value. (Id., at 11742 and reply to the Commission's questionnaire for United States & International Securities Corporation, Pt. I [Exhibit B-3].) The leverage possibilities of the common stock of the new company at organization thus served to rejuvenate the leverage ratio in the common stock of the parent company, which ratio had steadily diminished with the rise in the company's assets since 1924.

investment company securities on the stock exchanges and over the counter.<sup>120</sup> Whether these trading activities were bona fide stabilization efforts in connection with the public distribution of investment company security issues or merely constituted operations designed to drive up the market price need not be discussed at this point. However, the volume of such trading in investment company securities was substantial and the effect was often marked.

An example of extensive trading activities in investment company securities is provided by the purchase and sale transactions with dealers and with the public in 1929 by Founders General Corporation, the distributing affiliate for the United Founders Corporation group of investment companies.<sup>121</sup> In that one year Founders General Corporation purchased over \$220,000,000 and sold almost \$400,000,000 of securities of affiliated companies over the counter and on stock exchanges primarily in connection with the distribution of new issues of this system.<sup>122</sup>

The common stock of The Goldman Sachs Trading Corporation was also extensively traded in during most of the year 1929 by that corporation itself and by its sponsors and their associates. On February 3, 1929, the management of The Goldman Sachs Trading Corporation and Financial and Industrial Securities Corporation had concluded negotiations for a sale of all the assets of Financial and Industrial Securities Corporation to The Goldman Sachs Trading Corporation, which was to be submitted to a vote of the stockholders of the respective companies on February 21, 1929.<sup>123</sup> On February 4, 1929, The Goldman Sachs Trading Corporation commenced to purchase its own stock on the New York Curb Exchange,<sup>124</sup> and between the 4th and 7th, inclusive, of February 1929, this company had purchased 174,400 shares at progressively higher prices at a total cost of approximately \$33,350,000 and sold only 4,500 shares for total proceeds of approximately \$975,000.<sup>125</sup> Its purchases

<sup>120</sup> For a discussion of trading in investment company securities on exchanges, see Pt. Two, Ch. IV, 299 et seq. (House Doc. No. 70, 76th Cong.).

<sup>121</sup> Op. cit. supra, note 48, Commission's Exhibit No. 3737 (p. 173). This distributing agency for the entire Founders system was wholly owned by American Founders Corporation. (Id., Commission's Exhibits Nos. 3405 [p. 110], 3404-E-1 and 3404-E-2.)

<sup>122</sup> These figures are for the fiscal year ending November 30, 1929. (Op. cit. supra, note 48, Commission's Exhibit No. 3580. While this exhibit includes substantially all of such purchases and sales, the amounts do not represent the total of such purchases and sales.)

<sup>123</sup> The agreement provided that The Goldman Sachs Trading Corporation would increase its existing shares, by a declaration of a 100% stock dividend, to 2,250,000 shares and would issue a like amount of shares to the Financial and Industrial Securities Corporation stockholders. (Op. cit. supra, note 35, at 16126 et seq. and Commission's Exhibits Nos. 1679, 1680.) The purposes of The Goldman Sachs Trading Corporation's market activities in its own stock and its relationship to this merger will be described in a later chapter of this part of the report dealing with mergers and consolidations of investment companies.

<sup>124</sup> Until February 7, 1929, trading was confined to the existing stock of the trading corporation and the figures used in the text are those for the old stock. Thereafter, the figures used in the text refer to the stock of The Goldman Sachs Trading Corporation outstanding after declaration of the 100% stock dividend on shares on February 7, 1929, and the issuance, on February 21, 1929, of 2,250,000 shares to the stockholders of the Financial and Industrial Securities Corporation.

<sup>125</sup> Op. cit. supra, note 35, at 16140-4 and Commission's Exhibit No. 1665. On February 4, 5, 6, and 7, The Goldman Sachs Trading Corporation stock closed at new high prices which were made by this investment company's own purchases at the close of the market on each of these days. The closing prices for the stock on these days were 178, 179½, 187½, and 221, respectively. (Id., at 16148-52 and Commission's Exhibit No. 1665.)



constituted over 60% of the total trading on the New York Curb Exchange in that stock in those four days,<sup>126</sup> and undoubtedly contributed to the sharp rise in its market price.<sup>127</sup> This stock rose from \$136.50 per share on February 2, 1929,<sup>128</sup> a price 30% in excess of its asset value,<sup>129</sup> to \$222.50 per share on February 7, 1929, a price equivalent to twice its asset value.<sup>130</sup> By March 14, 1929, when The Goldman Sachs Trading Corporation's market activities in its own stock had terminated, it had accumulated 560,724 shares of its own stock,<sup>131</sup> or 12.5% of its then outstanding shares,<sup>132</sup> at a cost of \$57,021,936,<sup>133</sup> a sum roughly equivalent to twice the actual underlying asset value of these shares.<sup>134</sup> A portion of this stock<sup>135</sup> was sold to W. C. Durant,<sup>136</sup> who also conducted trading operations in the corporation's stock<sup>137</sup> until July 1929 with the knowledge of The Goldman Sachs Trading Corporation, which later shared in certain of Mr. Durant's profits and losses in this connection.<sup>138</sup> On September 14, 1929, Goldman, Sachs & Co., the sponsor of the investment company, organized a group of individuals and corporations to trade in the common stock of The Goldman Sachs Trading Corporation.<sup>139</sup> During the month of September 1929 purchases in this trading account which was operated by Goldman, Sachs & Co. accounted for 64% of the volume of trading in that stock on the New York Curb Exchange.<sup>140</sup> This account was terminated in December 1929, and immediately thereafter another account was formed, which in turn terminated its activities in March of the following year.<sup>141</sup> Although The Goldman Sachs Trading Corporation did not itself participate in these latter accounts, several of its subsidiaries and affiliated companies participated therein and sustained large losses.<sup>142</sup>

<sup>126</sup> Op. cit. supra, note 35, at 16141-3.

<sup>127</sup> Id., at 16128-34.

<sup>128</sup> Id., at 16137 and Commission's Exhibit No. 1665.

<sup>129</sup> Id., at 16157.

<sup>130</sup> Id., at 16141-4 and Commission's Exhibit No. 1665.

<sup>131</sup> Id., at 16221-3. Of this block, 98,000 shares were included in the assets of the Financial and Industrial Securities Corporation which were acquired by The Goldman Sachs Trading Corporation on February 21, 1929. (Id., at 16217 and Commission's Exhibit No. 1683.)

<sup>132</sup> Id., at 16221.

<sup>133</sup> Id., at 16221-3.

<sup>134</sup> Id., at 16249-53.

<sup>135</sup> The remainder of the stock was exchanged for the securities of various banking firms, banks, and bank holding companies of the Pacific Coast on which The Goldman Sachs Trading Corporation eventually suffered substantial losses. (Id., at 16726-31; and Commission's Exhibit No. 1736.)

<sup>136</sup> Id., at 16299 et seq.

<sup>137</sup> Id., at 16334-42, 16325.

<sup>138</sup> Id., at 16324-5.

<sup>139</sup> Id., at 16344 et seq., and Commission's Exhibits Nos. 1692, 1693.

<sup>140</sup> Id., at 16370-1.

<sup>141</sup> Id., at 16360 et seq., and Commission's Exhibits Nos. 1692, 1693.

<sup>142</sup> Id., at 16364-5. These subsidiaries and affiliates were Tucker, Hunter, Dulin & Co., Inc., a wholly-owned subsidiary of The Goldman Sachs Trading Corporation; Manufacturers Trust Company, 32% controlled by The Goldman Sachs Trading Corporation; and Shenandoah Corporation, 40% controlled by The Goldman Sachs Trading Corporation. Each suffered losses in excess of \$1,000,000 on their participations in these accounts. (Id., Commission's Exhibit No. 1667.)



## c. Market Premiums

A third significant factor in the investment company movement prior to the end of 1929 was the fact that most investment company securities were selling in the market at premiums above their asset values. Influenced by leverage, extensive trading in these securities, and other factors, the junior securities of a great majority of closed-end management investment companies, in particular, experienced rises in market prices exceeding the rise in their asset values. Whether these premiums resulted from rising market prices, public speculative fever, leverage, trading accounts and pools, misleading accounting or excessive valuations, pyramided systems or other causes, the net result was to provide a further incentive to the formation of investment companies and the sale of their securities. Furthermore, these conditions encouraged the creation of investment company systems with one investment company pyramided upon another or with cross holdings of different investment companies. As a consequence, asset values were further inflated through intercompany holdings and intersystem transactions on the basis of securities already selling at substantial premiums.

The security issues of newly organized and untried investment companies also sold at large premiums, sometimes on a "when-issued" basis before the actual issuance of the securities. These large premiums prevailed with respect to the security issues of nonleverage investment companies and to securities of companies of which as much as 10% of the offering price of the security was deducted as underwriting and distribution costs. For example, substantial premiums in the opening market price, varying from 50% to 150% and more, over asset value, existed in the stock of each new company organized in the United Founders Corporation group, possessing both leverage and nonleverage structures, during the two years 1928 and 1929.<sup>143</sup> The initial 2,000,000 shares of The Public Utility Holding Corporation of America common stock, which was eventually to have a paid-in value of \$25,000,000 at the time of its issuance,<sup>144</sup> commanded a market premium of \$35,000,000 over this anticipated paid-in value on a "when-issued" basis on September 6, 1929.<sup>145</sup> This premium prevailed one day after the corporation was created,<sup>146</sup> and ten days before the directors authorized the issue of any stock.<sup>147</sup> A further illustration is found in the aggregate premiums commanded by the securities of five investment companies in the United Founders Corporation group formed during 1928 and 1929. The aggregate market premium,

<sup>143</sup> Op. cit. supra, note 48, Commission's Exhibit No. 3739.

<sup>144</sup> Id., Commission's Exhibit No. 3424 (p. 12). In addition, the initial capitalization included 500,000 shares Class A common stock issued for \$6,250,000. (Ibid.)

<sup>145</sup> Op. cit. supra, note 48, Commission's Exhibit No. 3739. The concepts of net asset value and market price and the limitations upon their use are discussed in Part Two, Ch. IV, Appendix H (House Doc. No. 70, 76th Congress).

<sup>146</sup> Op. cit. supra, note 48, Commission's Exhibit No. 3423-1. The prevalence of market premiums during that period is indicated by the following testimony of Fred S. Burroughs, president of Public Utility Holding Corporation of America (id. at 25429): "As a matter of fact, it was the going rule of thumb at that time that any investment trust would sell at anywhere from two to four times the portfolio value of its assets. It was a fact that all investment trusts were selling on that basis. It seems kind of foolish now, but that was the situation."

<sup>147</sup> Op. cit. supra, note 48, Commission's Exhibit No. 3423 (3-b).

within a few days in each case after the time of the allotment of shares, was \$91,743,900 in excess of the \$76,800,000 of assets paid in by the original subscribers,<sup>148</sup> who consisted of a selected group of corporate and individual sponsors and their associates.

Reflecting the influence of market premiums, as well as the other factors of leverage and trading activities, was the market behavior of the common stock of Central States Electric Corporation. One hundred dollars invested in 1923 in the common stock of North American Company, which was the stock in which substantially all of the assets of Central States Electric Corporation and its affiliated companies were invested,<sup>149</sup> would have been represented by a market value of about \$1,650 on August 30, 1929.<sup>150</sup> Yet one hundred dollars invested in 1923 in the common stock of Central States Electric Corporation, itself a leverage company and the top investment-holding company of four other leverage investment companies,<sup>151</sup> would have had a market value of \$53,991 on August 30, 1929,<sup>152</sup> or over thirty times as much as the hundred dollar investment in the North American Company common stock. In twenty months, from December 31, 1927, to August 30, 1929, the aggregate value at market prices of all the common stock of Central States Electric Corporation rose from \$26,200,000<sup>153</sup> to \$680,000,000, practically all of which increase in market value was reflected in the holdings of Harrison Williams, who owned between 85% and 96% of the outstanding common stock during this time.<sup>154</sup> On the latter date, August 30, 1929, the market price of the common stock of Central States Electric Corporation was over 300% of its net underlying asset value.<sup>155</sup>

## B. Period, 1930 to Date

The stock market collapse in the latter part of the year 1929 marked the beginning of a substantial change in the development of the investment company industry. The assets of the industry declined from a peak of approximately \$8,000,000,000 at the time of the market break in 1929 to a low of \$2,000,000,000 in the middle of 1932, reflecting primarily substantial realized losses and unrealized depreciation on portfolio securities.<sup>156</sup> The loss to the stockholders of investment companies, particularly shareholders in leverage companies, was often more serious than the decline in the assets of those companies since these stockholders may have purchased the securities of these companies in the market at the substantial premiums over asset value at

<sup>148</sup> *Id.*, Commission's Exhibit No. 3739.

<sup>149</sup> *Op. cit. supra*, note 21, Commission's Exhibit No. 1207.

<sup>150</sup> *Id.*, at 12514-7.

<sup>151</sup> *Id.*, Commission's Exhibit No. 1207.

<sup>152</sup> *Id.*, at 12514-7.

<sup>153</sup> The underlying asset value of the common stock as of December 31, 1927, was greater than its market value, being \$33,500,000. (*Id.*, Commission's Exhibit No. 1206.)

<sup>154</sup> *Op. cit. supra*, note 21, at 12315-7 and Commission's Exhibit No. 1205. By December 31, 1934, the outstanding common stock of Central States Electric Corporation, of which Mr. Williams still held approximately 50%, had a total market value of only \$5,100,000 and possessed no asset value. (*Id.*, Commission's Exhibits Nos. 1205 and 1206.)

<sup>155</sup> The net underlying asset value of the common stock of Central States Electric Corporation is based on the asset values of the securities of affiliated companies in its portfolio and on the market value of other securities. (*Op. cit. supra*, note 21, Commission's Exhibit No. 1206.)

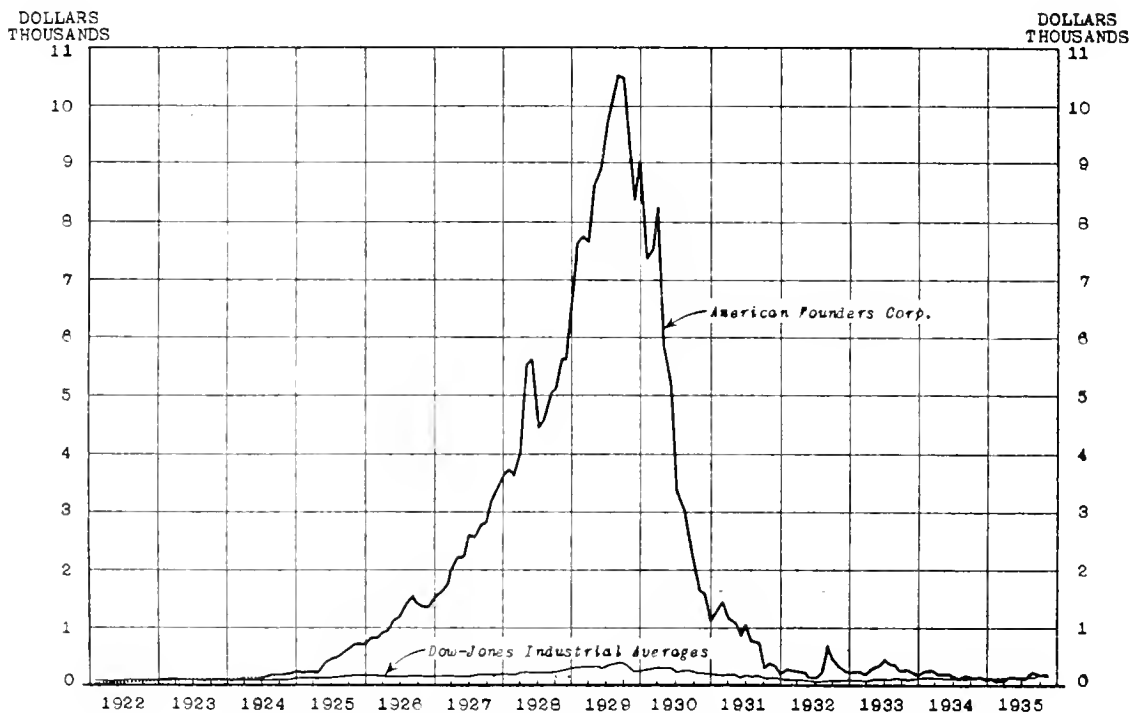
<sup>156</sup> Pt. Two, Ch. II, p. 32 (House Doc. No. 70, 76th Congress). This decline in assets was also due to the return of capital through repurchases, dissolutions, etc.

which they sold in the preceding period, and may then have sold their holdings at the substantial discounts below asset value which later existed.<sup>157</sup> Thus, the average dollar invested in July 1929 in a group of stocks comprising an index of common stocks of leverage investment companies, would have declined to about 2¢ in market price in June 1932, and a dollar invested in a comparable group of common stocks of nonleverage investment companies at the same time would have depreciated to about 21¢ in market price.<sup>158</sup>

A striking example of the market experience of a leverage stock during this period is provided by the common shares of American Founders Trust and its successor corporation. This is illustrated<sup>159</sup> by Chart 1, which compares the market experience of a share of common

CHART I<sup>1</sup>

MONTHLY CLOSING PRICES OF AMERICAN FOUNDERS CORPORATION COMMON STOCK<sup>2/</sup> COMPARED  
WITH MONTHLY CLOSING PRICES OF DOW-JONES INDUSTRIAL AVERAGES



1/ Derived from Public Examination, American General Corporation et al., Commission's Exhibit No. 3932.

2/ This series begins with the price of an original share of the predecessor trust and includes adjustments for subsequent split-ups.

stock of American Founders Trust and its successor, American Founders Corporation, from its inception in 1922 until the time of its consolidation into American General Corporation late in 1935 (giving effect to split-ups) with the Dow-Jones average of industrial stock prices for the same period.<sup>160</sup>

<sup>157</sup> See Pt. Two, Ch. IV, pp. 321-24 (House Doc. No. 70, 76th Cong.). This rapid shift from substantial premiums to substantial discounts from asset values occurred in both leverage and nonleverage companies, with the greater change taking place in the former. (Ibid. and Appendix H, p. 811 et seq.)

<sup>158</sup> Id., p. 314.

<sup>159</sup> Op. cit. supra, note 48, Commission's Exhibit No. 3832.

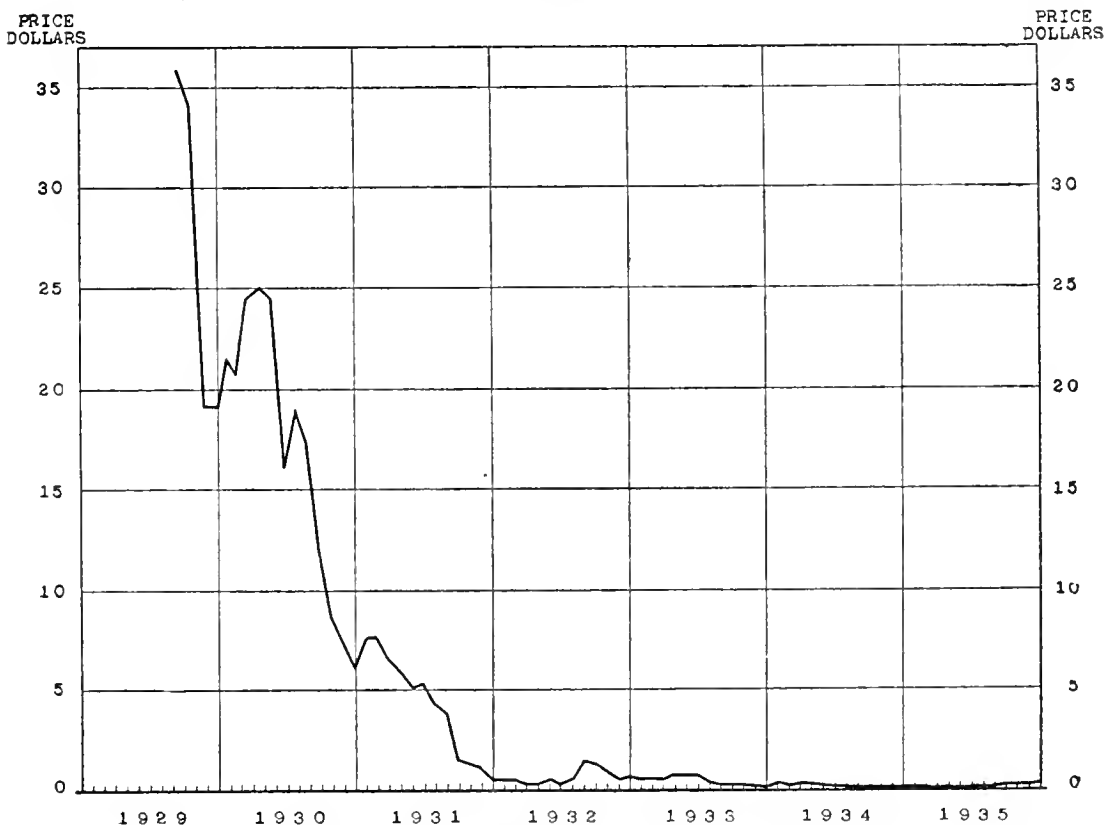
<sup>160</sup> There was no appreciable public participation in the common stock of American Founders Trust prior to November 30, 1925, when only \$529,000 in common stock capital had been raised. At the beginning of 1928 only \$7,281,000 of common stock was outstanding. (Id., Commission's Exhibit No. 3424-A-1.) These figures compare with the total of \$99,955,000 raised by the sale of common stock by this investment company during the 1922-1929 period (id., Commission's Exhibit No. 3424-C-1) and indicate the relatively great public participation beginning with 1928 when market prices began to rise sharply.

The movement in the market price of the common stock of Public Utility Holding Corporation of America from its inception in September 1929 until December 31, 1935, as shown by Chart 2, is an illustration of an investment in a company which was formed so late in 1929 that the investor had little opportunity to realize profits from a rising market. This company had substantial leverage, primarily through subsidiary companies,<sup>161</sup> which accelerated the decline in the asset and market values of its shares.

Approximately half of the total number of investment companies organized at any time during the 1927-1936 period went out of existence after 1929,<sup>162</sup> primarily as a result of the security market decline and the resulting poor performance of investment companies.

CHART 2<sup>1</sup>

MONTHLY CLOSING PRICES OF PUBLIC UTILITY HOLDING CORPORATION OF AMERICA, COMMON STOCK  
(NAME CHANGED TO GENERAL INVESTMENT CORPORATION - JULY 21, 1933)



<sup>1</sup> Derived from Public Examination, American General Corporation et al., Commission's Exhibit No. 3832.

The high rate of mortality, especially among the management investment companies, was largely the result of bankruptcies, receiverships, and dissolutions, and to a certain extent the result of mergers and consolidations.<sup>163</sup> While the number of new investment companies formed in any one year reached a peak of 265 in 1929, the number of new companies formed thereafter declined and, in 1936, only 26 new companies were organized.<sup>164</sup> Although the closed-end management investment company dominated the period prior to the end of 1929 and continued to constitute the major section of the industry after that time, the distribution of new capital issues by these companies

<sup>161</sup> *Ibid.*, Commission's Exhibit No. 3832 and No. 3423 (5A and 5B).

<sup>162</sup> Pt. Two, Ch. II, Table 16, p. 111 (House Doc. No. 70, 76th Cong.).

<sup>163</sup> *Ibid.*

<sup>164</sup> *Ibid.* The number of new investment companies formed increased from 25 in 1934 to 44 in 1935.

and the formation of new companies of this type practically ceased after 1930.<sup>165</sup>

Three major developments characterized the period following 1929: the first concerned the management of the assets of investment companies; the second related to buying, selling, and transferring the control of investment companies; and the third related to the growth of other types of investment companies which purported to overcome some of the defects of closed-end management investment companies but which introduced new problems of their own.

## 1. MANAGEMENT PRACTICES

Management investment companies, which held approximately 97% of the total assets of the industry at the end of 1929,<sup>166</sup> were vulnerable to the effects of the stock market collapse because of the very factors which had aided their previous expansion. Thus, the market prices of their own securities suffered because of the leverage, market trading, and market premiums which had accentuated their previous rise. The assets of these companies also felt the full impact of the depression, because of their heavy common stock investment.

The effect of the declining markets upon investment companies was also reflected in a variety of management practices. One activity of investment companies which was common during the period of the market decline was the repurchase of their own outstanding securities in the market at the discounts below their asset values then prevailing. During the years 1927 through 1936 investment trusts and investment companies repurchased or redeemed their own securities<sup>167</sup> at a total cost of approximately \$1,200,000,000. Of these substantial repurchases, closed-end management investment companies proper and investment-holding companies<sup>168</sup> for which detailed statistics were available expended approximately \$500,000,000, after deducting resales, or an amount equivalent to about 17% of the money raised by the sale of their own securities.<sup>169</sup> By far the greater part of this repurchasing activity, about 80% of the total repurchases for the 1927-1935 period, occurred after 1929.<sup>170</sup>

While retiring shareholders may have benefited from the market support which such repurchases afforded, yet, by selling their shares, they may have realized substantial losses due not only to the depreciation in the market values of portfolio securities but also to the prevailing market discounts from asset values at which the invest-

<sup>165</sup> Pt. Two, Ch. III, Table 60, p. 190 (House Doc. No. 70, 76th Cong.), and see discussion *infra*.

<sup>166</sup> *Id.*, Ch. II, Table 17, p. 112.

<sup>167</sup> *Id.*, Ch. III, pp. 183-7. This estimated aggregate amount does not include (1) proceeds to investors from net assets of companies upon liquidation and (2) distribution of dividends representing a return of capital. See also *id.*, Ch. VII, Table 155, p. 504.

<sup>168</sup> Open-end management investment companies and fixed and semifixed investment trusts also in effect repurchased their own securities. However, these repurchases were made at the election of shareholders usually pursuant to the provisions of charters or trust agreements and were at substantially the asset or liquidating values of the shares repurchased. Consequently they did not represent the free exercise of management discretion and did not yield any appreciable profits.

<sup>169</sup> *Op. cit. supra*, note 165, Ch. III, at 183 et seq., and note 10. This figure includes intercompany transactions. (*Id.*, pp. 232-6.)

<sup>170</sup> *Id.*, Table 64, p. 233.

ment company issues were selling and which discounts were not ordinarily eliminated by these repurchases. On the other hand, the difference between the asset values and the market prices at which these securities were repurchased accrued to the benefit of the remaining shareholders of such companies during a period of generally unfavorable operating conditions.<sup>171</sup> For example, at the end of 1929 The Lehman Corporation, which had been formed in September 1929 with \$100,000,000 of paid-in capital raised through the sale of 1,000,000 shares of common stock,<sup>172</sup> began repurchasing its stock. These repurchase activities extended through September 1934, but were heavily concentrated in the three years 1930-1932. In the course of this activity the investment company acquired 337,300 shares, or approximately 34%, of its outstanding common stock at a cost of \$17,130,000.<sup>173</sup> These reacquired shares, which represented an original cost to investors of approximately \$35,000,000, were repurchased by the company at an average discount of more than 25% below prevailing net asset values and resulted in an estimated book profit to the remaining shareholders of over \$6,000,000.<sup>174</sup>

In addition to repurchasing outstanding common stocks at market prices below asset values, investment companies also reacquired their outstanding senior securities at market prices below the amounts to which these securities would be entitled upon liquidation of the investment companies. These repurchases of senior securities were particularly popular during this period, as illustrated by the repurchase program from 1928 to 1934 of United States & International Securities Corporation, organized in October 1928 with publicly subscribed capital of \$50,000,000.<sup>175</sup> During those years the investment company reacquired for \$11,473,000 about half of its outstanding first preferred stock, representing an original aggregate cost to the public of \$24,634,300.<sup>176</sup> These repurchases were effected at an average discount of over 50% of the claims of these preferred stocks upon liquidation of the company and at prices substantially below the then current asset values of these securities, and benefited the junior stocks, which were held mainly by the parent investment company, United States & Foreign Securities Corporation.<sup>177</sup> Another illustration is provided by the three investment companies, Chicago Investors' Corporation, The Chicago Corporation, and Continental Chicago Corporation, all sponsored by Field, Glore & Company during the 1927-1929 period and subsequently merged to form a new The Chicago Corporation.<sup>178</sup> These investment companies repurchased and retired, at a cost of \$39,410,000, approximately 63% of their aggregate outstanding preference stocks, representing an original public investment<sup>179</sup> of some \$55,000,000. Approximately 56% of these repur-

<sup>171</sup> A discussion of various reasons for, and the volume of, repurchases is contained in Pt. Two, Ch. III, 232 et seq. (House Doc. No. 70, 76th Cong.).

<sup>172</sup> Reply to the Commission's questionnaire for The Lehman Corporation, Pt. V.

<sup>173</sup> Ibid.

<sup>174</sup> Ibid. and computed from figures supplied in Pt. IV.

<sup>175</sup> See discussion, *supra*.

<sup>176</sup> Reply to the Commission's questionnaire for United States & International Securities Corporation, Pt. II (Balance Sheet, Exhibit A, Schedule 18) and Pt. V (Table 16, sec. I).

<sup>177</sup> Id., Pts. II (Schedule 20-B), IV, and V (Table 15-A).

<sup>178</sup> Op. cit. *supra*, note 83, Pt. I.

<sup>179</sup> Id., Pts. II and V. The combined preference stocks of the three companies amounted to \$87,821,000.

chases<sup>180</sup> were made during 1930 at discounts from the claims of these shares upon liquidation.<sup>181</sup>

While the losses in a number of investment companies were attributable principally to the security market decline and general business decline, in many cases the substantial losses sustained by investment companies were the result of the numerous transactions which the sponsors, managers, officers, directors, and other controlling interests effected for their own account with the investment companies which they dominated. During the period after the stock market collapse in October 1929, many of these dominant persons, who were in financial straits, immediately turned to the large liquid resources of their investment companies to obtain assistance. These insiders often sold unmarketable securities or other properties, many of which were of doubtful value, to their investment companies or caused these companies to take over dubious and illiquid investments in which they were interested; compelled these organizations to assume large and onerous commitments on which these insiders were obligated, such as participations in underwritings, trading accounts, loans, and other commitments; required these companies to relieve them of existing liabilities and obligations to their investment companies; caused these organizations to finance clients of these insiders and companies in which they were interested; and induced the making of direct loans to insiders, often without any collateral or upon inadequate security. These various transactions were permeated with conflicting interests, and many were characterized by the absence of arm's-length dealing and by opportunities for overreaching.

The extent simply of the direct dealing by affiliated interests with the investment companies with which they were identified is partially indicated in the case of a group of 151 management investment companies proper which answered the Commission's questionnaire (companies which at one time had at least \$500,000 in assets and were still active as at the end of 1935), which directly purchased during the 1927-1935 period from such related interests portfolio securities at an aggregate cost of approximately \$162,000,000.<sup>182</sup> Of these purchases, \$76,000,000 were effected in 1929, with the most substantial portion after October of that year, and approximately \$58,000,000 were made in the years 1930 through 1933. Similarly, out of a total number of approximately 1,250 different direct security sales by related interests to these management investment companies proper, 330 were consummated in 1929 and 625 from 1930 through 1933. In addition to direct purchases of portfolio securities, these management investment companies proper repurchased in the year 1930 alone their own outstanding securities from such related interests in 110 separate transactions, involving a cost to these investment companies of approximately \$16,000,000.

These figures do not include the many millions of dollars of portfolio securities or investment company security issues sold by indirectly

<sup>180</sup> *Op. cit. supra*, note 83, Pts. II and V.

<sup>181</sup> *Id.*, Pts. IV and V. A substantial part of these repurchases were also a part of the plan of effecting the merger of the three companies.

<sup>182</sup> Replies to the Commission's questionnaire by 151 management investment companies proper, Pt. VII (Item 70). This item of the questionnaire requested data from these companies on their purchases of securities from officers, directors, or principal stockholders, or controlled organizations, and not from all types of affiliated interests.



affiliated interest to the "proper" companies; or sold directly by related interests to management investment-holding companies, to all types of management investment companies which went into bankruptcy or receivership or were dissolved; to the companies which were absorbed through mergers and consolidation; and to the companies which subsequently became part of the Atlas Corporation group, including The Goldman Sachs Trading Corporation, and of The Equity Corporation group, including the United Founders Corporation companies. Nor do these figures include other property or interests such as real estate, mortgages, commodities, loans, subparticipations in underwritings, and various business enterprises which these controlling persons sold directly to their investment companies or securities which were indirectly sold by these affiliated interests to their investment companies through the expedient of effecting the transaction in the open market. In addition, these figures do not include the substantial loans made directly by investment companies to such related interests. Some indication of the amount of these loans may be obtained from the fact that approximately 80% of the \$44,000,000 of loans reported by 63 investment companies proper as outstanding as at the end of 1930 were made to officers, directors, employees, and other affiliated interests.<sup>183</sup>

## 2. ACQUISITIONS AND MERGERS

A second characteristic of the period following 1929 was the practice of engaging in programs of acquisitions of control of investment companies, instituted by persons who were taking advantage of the depressed economic conditions and the general disfavor into which management investment companies had fallen. Investors of the preceding decade in investment companies had their enthusiasm dampened by the large losses sustained by these organizations and by the discounts from asset values at which their securities were selling, while many sponsors during this period came to regard investment companies as liabilities rather than as sources of profit. Furthermore, the relatively liquid nature of the assets of investment companies tended to give the control of such companies a definite value and a ready marketability, and many individuals and companies, alert to the possibilities of profit from the control of such funds,<sup>184</sup> were willing to pay sums substantially in excess of asset and market values to existing controlling interests for their holdings in companies to be acquired.<sup>185</sup> Dealing in the control of investment companies was often

<sup>183</sup> Based upon an analysis of replies to the Commission's questionnaire by a group of management investment companies proper, Pt. II. The extent of the loans by these companies is by no means fully reflected in these figures, since loans reported to this Commission are only year-end balances and do not include intermediate transactions, often more substantial in amount, or reflect reductions due to write-offs.

<sup>184</sup> The same inducements which motivated the formation of investment companies in the preceding period still existed. (Pt. One, Ch. III, pp. 62-63 [House Doc. No. 707, 75th Cong.,].)

<sup>185</sup> Offers to purchase control were even advertised in newspapers. For example, one recent advertisement stated (*The New York Times*, February 28, 1936):

"WANTED . . . THE CONTROL OF AN INVESTMENT TRUST or a COMMERCIAL FINANCING COMPANY. One of our clients, a large investment banking firm, is interested in acquiring the controlling interest in an established licensed investment trust of management type—or a commercial financing company, etc."



facilitated by the public dissatisfaction with the old managements and the availability of most investment company securities at substantial discounts from their underlying asset values.

Acquisitions and mergers of investment companies therefore became an important aspect of the history of the industry after the end of 1929. Up to December 31, 1936, a period of seven years, 163 investment companies were merged or consolidated with or acquired by other investment companies.<sup>186</sup> These consolidations and acquisitions do not include the numerous changes in control within individual investment companies. Approximately \$873,000,000 of the securities of closed-end management investment companies proper and management investment-holding companies were issued during the 1927-1935 period in exchange for securities of other investment companies in connection with such plans of merger or consolidation.<sup>187</sup>

This type of activity was carried on by relatively few individuals or companies. In May 1930, the Atlas Corporation, sponsored by Floyd Odium and his associates, commenced its program of expansion<sup>188</sup> through the acquisition of other investment companies and by October 1936 had taken over 18 investment companies with aggregate assets of approximately \$129,000,000.<sup>189</sup> Of these companies, the assets of 15 were absorbed and the companies were dissolved, while the remaining three were consolidated with Atlas Corporation.<sup>190</sup> Similarly, The Equity Corporation was organized in December 1932 by Wallace Groves and his associates, with initial assets of approximately \$300,000,<sup>191</sup> for the professed purpose, in addition to operating as an investment company, of expanding by acquiring and consolidating other investment companies. Most important among its acquisitions was the United Founders Corporation group of companies. This program of acquisition was conducted, subsequent to May 1933, by the David M. Milton and Ellery C. Huntington, Jr., interests which had then acquired control of The Equity Corporation. Through these acquisitions, mergers, and consolidations the assets of The Equity Corporation and its investment company subsidiaries increased to approximately \$25,000,000 at December 31, 1936. A total of 21 investment companies, the outstanding stocks of which were held by the public, was absorbed by The Equity Corporation or its subsidiaries. During this period of acquisition, The Equity Corporation, either directly or through its investment company subsidiaries, acquired working control of portfolio corporations with aggregate resources of approximately \$205,000,000.

Tri-Continental Corporation, with assets of approximately \$76,500,000 at January 1, 1930, and sponsored by J. & W. Seligman & Co.,

<sup>186</sup> *Op. cit. supra*, note 162.

<sup>187</sup> Pt. Two, Ch. III, p. 196 (House Doc. No. 70, 76th Cong.). Companies in the Atlas Corporation and The Equity Corporation groups accounted for over 60% of this amount.

<sup>188</sup> Public Examination, Atlas Corporation, at 17708-11, 17718-22.

<sup>189</sup> *Id.*, Commission's Exhibit No. 2033.

<sup>190</sup> *Id.*, Commission's Exhibit No. 1958.

<sup>191</sup> The full details and documentation for the acquisition program of The Equity Corporation are contained in the Report of this Commission on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Pt. VII, Sec. IV, A.

investment bankers,<sup>192</sup> absorbed three other investment companies<sup>193</sup> during the period 1931–1935. In addition, Tri-Continental Corporation acquired stock interests in or management contracts with four other investment companies and a fire insurance company.<sup>194</sup> By December 31, 1936, Tri-Continental Corporation and the other companies in the group had gross assets of approximately \$170,000,000.<sup>195</sup>

In November 1935, Ernest B. Warriner, who had previously been associated with Wallace Groves in the latter's acquisition of control of Interstate Equities Corporation, Chain & General Equities, Inc., Yosemite Holding Corporation, Granger Trading Corporation and Joint Investors, Inc.,<sup>196</sup> commenced to acquire control of a group of investment companies. Within a period of one year, Mr. Warriner succeeded in acquiring, with an investment of \$139,000 which he borrowed from the Groves interests, control of International Equities Corporation, which acquired control of General Investment Corporation, which in turn acquired control of Standard Investing Corporation, and approximately one-fourth of the voting power in Utility Equities Corporation.<sup>197</sup> The aggregate assets of these four investment companies approximated \$32,000,000.

In July 1934, Henderson Brothers, of Boston, Massachusetts, who had been engaged in the business of selling radios, had an interest in a small investment company, the World Investment Trust. With this investment company as a nucleus, Henderson Brothers and an associate, Robert L. Moore, commenced a program of the acquisition of other investment companies. With a personal investment of not more than \$80,000, they built up, within a period of three years, a pyramided investment company system giving them control of seven investment companies whose aggregate assets approximated \$25,000,000.<sup>198</sup> These investment companies were Beacon Participations, Inc., Atlantic Securities Co. of Boston, Allied International Investing Corporation, and a group of four investment companies, namely, Standard Investing Corporation, International Equities Corporation, General Investment Corporation, and Utility Equities Corporation, which group was acquired from Ernest B. Warriner in March

<sup>192</sup> Summary statement supplied the Commission for Tri-Continental Corporation (predecessor company) and Tri-Continental Allied Company, Inc. (Exhibit III-D., and items I-b, II-b, and III.)

<sup>193</sup> These three investment companies were Wedgwood Investing Corporation, Investors Equity Company, Inc. and Graymur Corporation. (Derived from supplementary information supplied the Commission for Tri-Continental Corporation, and Public Examination, Tri-Continental Corporation, at 18552–9, 18577–83, 18585–6.)

<sup>194</sup> These companies were Selected Industries, Inc., The Broad Street Investing Co., Inc., Capital Administration Co., Ltd., Blue Ridge Corporation, and Globe and Rutgers Fire Insurance Company. (Derived from supplementary information supplied the Commission for Tri-Continental Corporation, and Public Examination, Tri-Continental Corporation, at 18490–2, 18512–14, 18559–77, 18583–85, 18586–96.)

<sup>195</sup> Public Examination, Tri-Continental Corporation, at 18538–40. This figure represents gross assets without eliminating intercompany holdings. (Id., at 18538.) It includes only one-half, or \$25,835,000 of the total assets of Blue Ridge Corporation. (Id., at 18539.)

<sup>196</sup> For a detailed discussion of the manner in which Wallace Groves acquired control of these companies, see Ch. II, *infra*, *Investment Companies Acquired and Controlled by Wallace Groves*, pp. 181–227.

<sup>197</sup> For a detailed discussion of these acquisitions see Ch. II, *infra*, *General Investment Corporation*, pp. 497–621.

<sup>198</sup> Public Examination, General Investment Corporation, at 15311–23. This figure includes intercompany holdings.

1937 for a total of approximately \$2,800,000.<sup>199</sup> Of this amount, \$800,000 was supplied by Beacon Participations, Inc., Atlantic Securities Co. of Boston, and Allied International Investing Corporation to acquire control of Standard Investing Corporation. The balance of \$2,000,000 was thereafter supplied by Standard Investing Corporation to purchase from Mr. Warriner control of International Equities Corporation, which controlled General Investment Corporation, which, in turn, held the one-quarter interest in Utility Equities Corporation.

As recently as August 1937, another group, including Philip A. Frear, Vincent E. Ferretti, and George H. Clayton, Jr., who apparently had never been connected with the sponsorship of any investment company, secured, within a period of five months, control of four investment companies whose total assets approximated \$12,500,000, without the expenditure of any personal funds, but used the assets of the various investment companies acquired to pay for such control. The investment companies so acquired consisted of First Income Trading Corporation, Continental Securities Corporation, Corporate Administration, Inc. (which managed and supervised the open-end investment company known as Administered Fund Second, Inc.), and Reynolds Investing Co., Inc.<sup>200</sup>

Contemporaneously with the acquisition of these investment companies, another group, consisting of Leo S. Solomont, Ralph H. Robb, and Thomas W. Morris, who had been associated with the Frear, Ferretti, and Clayton group in their acquisition of investment companies, commenced with other associates their independent acquisition of other investment companies. Within a period of approximately three months, from the middle of December 1937 to the first of March 1938, they succeeded in acquiring control of three investment companies, Insuranshares Corporation of Delaware, Bond & Share Trading Corporation, and Burco, Inc.<sup>201</sup> Control of these companies, whose aggregate assets approximated \$2,300,000, was acquired with no personal investment and substantially by the same technique used by the Frear, Ferretti, and Clayton group in their acquisition of investment companies.

### 3. DEVELOPMENT OF SPECIAL TYPES OF INVESTMENT COMPANIES

A third significant phase of the depression period, in its relation to abuses in the organization and management of investment companies, was the revival by sponsors of the distribution of investment trust and investment company securities by actively promoting types of trusts and companies with special features of structure and operation which might overcome popular prejudices against these organizations.<sup>202</sup>

After the stock market break in the fall of 1929 management investment companies sustained large losses and their securities sold at sub-

<sup>199</sup> Op. cit. supra, note 197.

<sup>200</sup> For a detailed discussion of these acquisitions see Ch. II, infra, *Activities of Fiscal Management Group in Acquisition of First Income Trading Corporation, Continental Securities Corp., Corporate Administration, Inc., and Reynolds Investing Co., Inc.*, pp. 350-437.

<sup>201</sup> For a detailed discussion of these acquisitions see Ch. II, infra, *Activities of Northern Fiscal Group in Acquisition of Insuranshares Corp. of Delaware, Bond & Share Trading Corp., and Burco, Inc.*, pp. 437-494.

<sup>202</sup> Pt. Two, Ch. III, pp. 187-92 (House Doc. No. 70, 76th Cong.).

stantial discounts. Investment company management fell into popular disfavor and sales resistance developed on the part of the public to securities of these organizations. Sponsors, finding that it was virtually impossible to raise capital from the public for management investment companies and finding that their distribution profits were curtailed, sought some vehicle which could overcome this public reaction. It was at this time that the substantial growth of fixed and semifixed trusts commenced.<sup>203</sup> Sponsors emphasized that in the fixed and semifixed trust type of investment company management was eliminated or drastically limited and, in addition, emphasized that these shares did not sell at a discount since the shareholder could redeem his certificates at about asset value.

Since the profit to the sponsors in fixed and semifixed trusts lay in the pricing of the shares and their distribution, the various abuses which arose were mainly in connection with the computation of the price at which the shares were sold to the public, the sales load charged, the representations made in the literature, and the type of salesmanship pursued, all of which eventually created resistance to the sale of these securities. For example, not only was the published load often excessive but, in addition, various hidden charges were imposed upon investors.<sup>204</sup>

Furthermore, the provisions of the trust indentures often created difficulties which were used as a reason for the formation of new trusts with alleged improvements. Thus the provisions to remove management discretion, eliminating underlying securities from the portfolios of fixed trusts under automatic formulae, proved unworkable and in many cases resulted in eliminating securities at low points in the market. Purporting to overcome this defect, sponsors brought out new trusts with more flexible provisions for eliminating underlying securities. By bringing out these new trusts, sponsors were able to solicit the shareholders of an earlier trust, when its sales were diminishing, to exchange their shares for those of the new one, offering some discount on the sales price of the new shares as an inducement for the exchange. The investor who exchanged his trust shares paid a new load and often received a security little different from the one surrendered. After repeating this switching process several times, many sponsors eventually turned to the open-end management type trust or company, into which the holders of these fixed and semifixed trust shares often were finally exchanged.

As the business tide began to turn in early 1933, the disfavor into which management investment companies had fallen began to diminish although their securities were still selling in the market at discounts below asset values. To popularize the sale of management

<sup>203</sup> Ibid. and Table 60, p. 190.

<sup>204</sup> An investor under the impression that he was paying 7% of the selling price of the trust shares as a sales load was frequently paying upward of 11%, the excess in most cases representing additional profits to the sponsor. Among such hidden sources of profit were loading charges computed on brokerage fees, on odd-lot premiums, on taxes paid by investors, and on other similar items; upward adjustment of the price of shares to the next higher fraction of a dollar, thus adding in some cases as much as 5% to the offering price of the shares; charging the "asked" prices of underlying securities in determining the offering or sales price of the fixed trust certificates and allowing only "bid" prices on the underlying securities in computing the redemption price; and in some cases payments of interest on the trust funds to the sponsor instead of to the certificate holder. (See the supplemental report on fixed and semifixed investment trusts.)

investment company securities sponsors then directed their activities to the promotion of the open-end type of management investment company which gave the stockholder the right to obtain approximately the current underlying asset value of his shares at any time.<sup>205</sup> This right of redemption of open-end investment company shares at about asset value of course eliminated discounts on these securities since the market price would have to be at least the approximate asset value at which the securities could be redeemed with the issuing company. Limited restrictions upon the percentage of assets of the open-end company that could be invested in securities in one company or field and other restrictions upon management were sometimes provided, so that emphasis could be placed, when these issues were being distributed, upon the fact that there were limitations on the discretion of management. However, the salient characteristic of the open-end investment company, as in the fixed and semifixed investment trust, was that the investor was given a right of redemption so that he could liquidate his investment at or about asset value at any time that he was dissatisfied with the management or for any other reason.<sup>206</sup> After 1933 the sale of open-end investment company securities increased in volume and in recent years they have constituted the majority of all investment company securities registered with this Commission<sup>207</sup> and issued.<sup>208</sup>

Contemporaneous with and related to the growth of open-end investment companies, particularly after 1933, was the development of the installment investment plan companies and the companies issuing face amount certificates.<sup>209</sup> The installment investment plans were essentially methods of merchandising investment trust or investment company securities on a periodic or installment payment basis. The underlying securities of these plans consisted of issues of all types of investment companies, usually fixed trust shares.<sup>210</sup> Face amount installment certificates, being in the nature of contracts to pay to the purchasers the face amounts of the certificates at specified maturities, or their attained surrender values at earlier dates have also ordinarily been sold on an installment basis.<sup>211</sup>

Statistics of the sales activities in the various types of securities offered by the sponsors of investment trusts and investment companies during the period following 1929 in general support this pattern of development.<sup>212</sup> While the closed-end management investment companies were still popular in 1930, accounting for over one-half of the total sales of investment company securities, fixed and semifixed investment trust sales rose from a relatively negligible amount to attain their greatest dollar volume in their entire history in that year. Thus

<sup>205</sup> Pt. Two, Ch. III, p. 212 (House Doc. No. 70, 76th Cong.).

<sup>206</sup> *Id.*, p. 213.

<sup>207</sup> *Id.*, Appendix C, Table 234, p. 763, and Table 236, p. 766.

<sup>208</sup> *Id.*, Table 60, p. 190.

<sup>209</sup> *Id.*, pp. 222-6. See the Commission's supplemental reports on installment investment plan companies and companies issuing face amount certificates.

<sup>210</sup> Pt. One, Ch. II, p. 31 (House Doc. No. 707, 75th Cong.), and Pt. Two, Ch. III, p. 222 (House Doc. No. 70, 76th Cong.).

<sup>211</sup> Pt. One, Ch. II, p. 32 (House Doc. No. 707, 75th Cong.), and Pt. Two, Ch. III, p. 226 (House Doc. No. 70, 76th Cong.).

<sup>212</sup> Pt. Two, Ch. III, Table 60, p. 190 (House Doc. No. 70, 76th Cong.). The figures in this table exclude investment companies (other than fixed and semifixed investment trusts) with assets of less than \$500,000 at the end of 1935.

fixed and semifixed trusts attracted \$336,000,000 of new capital in 1930, representing more than 40% of all investment company securities sold in that year. Although in the following year, 1931, fixed and semifixed trust sales dropped to \$266,000,000, their importance relative to the other types of investment trusts and companies increased, for these sales constituted almost 80% of the new capital raised by the entire industry. The popularity of the shares of fixed and semifixed investment trusts waned rapidly through 1932 and 1933, when the annual volumes of sales of this type of security were \$74,000,000 and \$12,000,000, respectively.

On the other hand, sales of the shares of open-end investment companies aggregated only \$22,000,000 in 1931; increased slightly to \$26,000,000 in 1932; and rose to \$82,000,000 in 1933. From 1932 to 1933 the sales of the securities of this type of investment company increased from 21% to 66% of the volume of sales of securities of all types of investment trusts and investment companies. From 1933 to the end of 1936, during which period open-end investment company sales were \$360,000,000, the shares of these companies accounted for most of the sales of investment company securities.<sup>213</sup> In the year 1936 total sales<sup>214</sup> of securities of open-end investment companies amounted to 61% of all investment company securities distributed.<sup>215</sup> Estimated total sales for fixed trusts in the same year amounted to only \$15,000,000,<sup>216</sup> and those sales were mostly to installment investment plans which used the shares of fixed trusts as their underlying securities.<sup>217</sup> On the other hand, from 1932 through 1936 the sales of installment investment plan certificates increased over sixfold, from approximately \$2,000,000 to \$15,000,000, while the sales of face amount installment certificates more than doubled, increasing from \$16,000,000 to \$33,000,000.<sup>218</sup>

This sequence of development was also reflected in the promotional activities of individual sponsors who exploited each type of investment company as it gained public favor. Thus, the distribution of fixed trust shares was concentrated in six sponsors who accounted for almost 90% of the total assets of that group throughout the 1927-1935 period<sup>219</sup> and all of them followed substantially the same pattern in their sales methods. During the years 1930 and 1931, these same sponsors promoted fixed and semifixed trust shares vigorously,<sup>220</sup>

<sup>213</sup> *Ibid.*

<sup>214</sup> This increase in sales was possibly influenced by the provisions of the Revenue Act of 1936 which accorded a preferential tax treatment to so-called "mutual investment companies," one of the characteristics of which was defined as the right of the shareholder to Quarterly Income Shares, Inc., which had amended its charter so as to eliminate the shareholders' rights to redeem at asset value, restored this privilege upon the passage of the Revenue Act of 1936 so as to qualify as a mutual company. The Revenue Act of 1938 contains substantially the same provision. (52 Stat. 552, 553, [26 U. S. C., 1938 Supp., secs. 329i and 329j].) See also Pt. Two, Ch. III, p. 212, and note 47. (House Doc. No. 70, 76th Cong.)

<sup>215</sup> Pt. Two, Ch. III, Table 60, p. 190. (House Doc. No. 70, 76th Cong.)

<sup>216</sup> *Ibid.*

<sup>217</sup> *Id.*, p. 212.

<sup>218</sup> *Op. cit. supra*, note 215.

<sup>219</sup> These six sponsors were Calvin Bullock, Massachusetts Distributors, Inc., Maryland Sponsors, Inc., Distributors Group, Inc., Bank and Insurance Shares, Inc., and Lord Abbett & Co., Inc. (Pt. Two, Ch. II, Table 15, p. 101.)

<sup>220</sup> Pt. Two, Ch. III, p. 212 and Table 60, p. 190. (House Doc. No. 70, 76th Cong.)

sometimes offering new fixed trust shares in exchange for shares of other investment trusts they had originally offered.<sup>221</sup> However, when the popular interest in fixed and semifixed trusts waned in 1932, they sponsored open-end investment companies into which they attempted to switch holders of their fixed trust shares.<sup>222</sup> For example, one of these sponsors, Calvin Bullock, who had organized two fixed trusts prior to the end of 1927<sup>223</sup> and had then sponsored two closed-end management investment companies in 1928 and 1929,<sup>224</sup> brought out two new fixed trusts in 1930.<sup>225</sup> However, in 1932, when the fixed trust movement had begun to spend itself,<sup>226</sup> Calvin Bullock organized six open-end investment companies whose shares were thereafter actively offered by his sales organization<sup>227</sup> not only to new investors, but to the holders of the shares of fixed trusts which he had previously sponsored. Ross Beason & Co., Inc. followed the same trends. Having co-sponsored a series of fixed trusts prior to 1929,<sup>228</sup> it set up Corporate Trust Shares, a fixed trust, in 1929,<sup>229</sup> and was able to take full advantage of the fixed trust boom after the market collapse. It also organized four additional fixed trusts during 1931 and 1932, making exchange offers to the holders of various of the existing series upon the organization of a new series.<sup>230</sup> In January 1933, this sponsor launched an open-end investment company, Quarterly Income Shares, Inc.,<sup>231</sup> into whose securities it offered to trade the holders of shares of fixed trusts previously organized and as a result consummated exchanges of the total value of \$15,138,000.<sup>232</sup>

Massachusetts Investors Trust, Incorporated Investors and State Street Investment Corporation, the three Boston open-end investment companies, also experienced substantial expansion by 1933, when open-end investment companies succeeded fixed trusts as the largest selling vehicle, to become the largest investment companies of their type.

In general, the placing of complete or limited restrictions upon investment policies was represented as a cure for the management evils of the past, while the right accorded stockholders to require the redemption of their securities at the approximate current underlying asset values was designed to eliminate the market discounts from such asset values which prevailed on various investment company securities.<sup>233</sup> This right of redemption was usually accompanied by continuous sales campaigns of new shares to prevent diminution of the investment company's funds, and the merchandising of such

<sup>221</sup> *Id.*, p. 221.

<sup>222</sup> *Ibid.*

<sup>223</sup> Public Examination, Calvin Bullock Trusts, at 3709, 3712, and 3716.

<sup>224</sup> *Id.*, at 3710, 3717-18, and 3725.

<sup>225</sup> *Id.*, at 3709-10 and 3718-19.

<sup>226</sup> *Id.*, at 3722.

<sup>227</sup> *Id.*, at 3710 and 3720-7.

<sup>228</sup> Public Examination, Ross Beason & Co. Group, at 10968-9.

<sup>229</sup> *Id.*, at 10969.

<sup>230</sup> *Id.*, at 10969-72.

<sup>231</sup> *Id.*, at 10973-4.

<sup>232</sup> *Id.*, at 11291-2 and Commission's Exhibit No. 1096.

<sup>233</sup> While these characteristics do not apply to companies issuing face-amount certificates, the abuses in connection with distribution methods and loading charges are generally applicable thereto. (See the supplemental report on companies issuing face amount installment certificates.)



securities has been likened to the merchandising of soap.<sup>234</sup> The problems presented by these various types of investment trusts and companies active in the distribution of their shares after 1929 were therefore usually concerned with the methods of pricing and distributing these shares.

### III. SIGNIFICANT STATISTICAL ASPECTS OF THE INDUSTRY

A review of certain over-all aspects of investment trusts and investment companies may be helpful in a consideration of the significance and possible consequence of abuses in the industry. While detailed statistics of various aspects of the industry have been presented in Part Two of this report, some of the general phases of those studies will be briefly recapitulated.<sup>235</sup>

#### A. Size and Nature of Ownership

Investment trusts and investment companies by 1929 had grown to be and, despite a considerable shrinkage of their assets since that time, still are an important factor in our national economy. A total of 558 investment companies of all types with aggregate assets of \$4,502,000,000 were known to have been in existence at the end of 1936.<sup>236</sup> The large amount of capital invested in these organizations and the wide diffusion of the public ownership of their securities have created a situation in which a substantial portion of the investing public throughout the country has a direct and immediate interest in investment trusts and companies. It has been estimated that at December 31, 1935, approximately 1,500,000 different individuals, after eliminating duplications,<sup>237</sup> were security holders of investment trusts and companies.<sup>238</sup> The growth of the public interest in this medium of investment is indicated by the fact that at the end of 1927 such security holders slightly exceeded an estimated 300,000 in number.<sup>239</sup> Management investment companies accounted for more than three-fifths of the total of all holders of record of the securities of all types of investment trusts and companies at the ends of both 1927 and 1935,<sup>240</sup> and in all probability maintained the same proportion throughout the intervening period. The remainder has consisted of holders of certificates of fixed and semifixed investment trusts, installment investment plans, and face amount installment certificate companies.<sup>241</sup> Probably one out of

<sup>234</sup> See statement of William Parker, Public Examination, Incorporated Investors, at 2572.

<sup>235</sup> Reference must be made to the detailed studies in Pt. Two for a complete understanding of the significance of the statistical data summarized here.

<sup>236</sup> Pt. Two, Ch. II, Table 2, p. 27 (House Doc. No. 70, 76th Cong.). At the end of 1937 the assets of the industry had declined to an estimated \$2,800,000,000, but by the end of 1938 much of this decline had been recovered. (Id., pp. 29-32.)

<sup>237</sup> These duplications are the result of the holding by one person of the securities of more than one investment company.

<sup>238</sup> Pt. Two, Ch. V, pp. 369-71 (House Doc. No. 70, 76th Cong.).

<sup>239</sup> Id., pp. 373-6.

<sup>240</sup> Ibid. and Table 111, p. 370 and Table 113, p. 374.

<sup>241</sup> Ibid.



every ten investors in the country at present is a participant in an investment trust or company.<sup>242</sup>

Stockholders of management investment companies are located in every state,<sup>243</sup> while the companies themselves are chiefly located in the main financial centers,<sup>244</sup> indicating the interstate nature of the distribution process of investment company securities. A concentration of stockholders, due in part to holdings by brokers and nominees, appears in those states in which important financial centers are located, particularly New York, Massachusetts, Illinois, and California.<sup>245</sup> Furthermore, between 50% and 60% of the larger management investment companies proper are located in New York City and represent from two-thirds to three-quarters of the total assets of that group.<sup>246</sup>

The great majority of the stockholders of investment trusts and companies are apparently investors of small amounts. An analysis of the distribution of ownership of common and preferred stocks of a group of large investment companies proper shows that the great majority of stockholders held relatively small blocks of stock. In terms of market value, somewhat over 50% of all the common stockholders of these companies,<sup>247</sup> individually held shares aggregating \$500 or less at the end of 1936, and nearly 70% held shares worth \$1,000 or less. Of all the preferred stockholders well over one-third individually held shares with a market value of \$500 or less and over one-half held shares worth \$1,000 or less. The percentage of holders of small amounts was still greater among investment-holding companies,<sup>248</sup> and was even more pronounced among investors in fixed and semifixed trusts, installment investment plans, and face amount installment certificate companies.<sup>249</sup> Thus it appears that a considerable portion of the capital raised by investment trusts and companies represents the participation of widely scattered small security holders, who were virtually powerless to exercise any concerted effort to prevent or eliminate various malpractices and deficiencies, or to remove incompetent or dishonest management.

On the other hand, a comparatively small number of stockholders has held a substantial portion of the outstanding voting shares of investment trusts and investment companies. This concentration of ownership, together with the wide diffusion of the balance of the stock, has perpetuated the control of dominant personalities and has constituted a factor contributing to the development and continuance of abuses.<sup>250</sup> Significant stock control or influence by sponsors, directors, officers, and other affiliated interests was greatest and most common in

<sup>242</sup> *Op. cit. supra*, note 238.

<sup>243</sup> Pt. Two, Ch. V, pp. 396-7 (House Doc. No. 70, 76th Cong.).

<sup>244</sup> *Id.*, Ch. II, pp. 60-1.

<sup>245</sup> *Id.*, Ch. V, pp. 396-7. The extent of the geographical distribution of stockholders is indicated by a few specific examples of varying but recent dates within the period. The shareholders of National Investors Corporation resided in 41 States; of Incorporated Investors, in every State; of Consolidated Investment Trust, in 40 States. (*Ibid.*)

<sup>246</sup> *Id.*, Ch. II, Chart 14, p. 61, and Table 27, p. 127.

<sup>247</sup> For detailed analyses, see *id.*, Ch. V, pp. 385-7.

<sup>248</sup> *Id.*, Table 125, p. 434 (Cf. Table 116, p. 386). See also p. 433.

<sup>249</sup> *Id.*, pp. 362-6. See also pp. 441-5.

<sup>250</sup> One-fifth of 1% of the number of common stockholders of a group of 14 management investment companies studied held 20% of the outstanding common shares at the end of 1936. (Pt. Two, Ch. V, Table 117, p. 389 [House Doc. No. 70, 76th Cong.].)

the leverage companies.<sup>251</sup> Of 122 management investment companies proper studied, affiliated interests, in 1935, held more than 10% of the voting power in over three-fourths of the closed-end leverage companies, in over one-half of the closed-end nonleverage companies, and in about one-fifth of the open-end companies.<sup>252</sup> While there was a greater number of small stockholders in investment companies, the holdings of the large investors were sufficient to constitute blocks of substantial importance and influence, and frequently to provide working control. A specific indication of the concentration of aggregate common stock holdings in a few hands is the fact that in 1936 only 2% of the number of all the stockholders in 14 large management investment companies proper held 45% of the total shares outstanding.<sup>253</sup>

Detailed study of individual investment companies has shown that control generally rests with a small group.<sup>254</sup> Control of investment companies as a practical matter is exercised by the management groups and the interests affiliated with these groups. This control is acquired or retained in the investment company field either through strategic stock ownership or other control devices such as management contracts, voting trusts, special classes of voting stocks or trusteeships under common law, or business trusts. Furthermore, small stockholders are unable effectively to exercise their combined voting power because of the inadequacies of voting machinery, the costliness of conducting a campaign against the existing management, and the smallness of their individual stakes. As a consequence, management groups have been able to maintain control even when they have had only minority or negligible stock holdings.<sup>255</sup>

## B. Concentration of Assets

A substantial proportion of the assets of the investment trust and investment company industry has been concentrated in a relatively few large companies throughout the period. The degree of this concentration is indicated by the large proportion of total assets of the industry owned by investment companies which constituted only 5% of the number of companies at the year-ends 1929 and 1936. As of December 31, 1929, out of 675 investment companies<sup>256</sup> with aggregate assets of over \$7,000,000,000, 34 companies (companies constituting the largest 5% of the total number) possessed almost \$4,300,000,000 of assets.<sup>257</sup> By the end of 1936, 28 investment companies out of a total of 558 investment companies in existence at that time,

<sup>251</sup> Pt. Two, Ch. V, pp. 404-9 (House Doc. No. 70, 76th Cong.). The term "affiliated interests" is used to designate management groups and connected interests (note 60).

<sup>252</sup> *Id.*, Table 121, p. 410.

<sup>253</sup> *Id.*, Table 117, p. 389.

<sup>254</sup> *Id.*, pp. 398-9. For more complete discussion of the control aspects of investment companies see p. 398 et seq.

<sup>255</sup> See *id.*, p. 399, and note 64, p. 401. Control of the proxy machinery by affiliated interests was substantially aided by ready access to stockholders' lists, friendly relationship with brokers and other nominees, and the use of corporate funds to finance proxy solicitations. Representation at annual meetings of investment companies in person and by proxy did not average more than 60% of the voting stock. Thus a block of more than 30% of the outstanding votes usually would be tantamount to absolute control at the meeting. In cases where a smaller percentage of votes was represented, absolute control might be exercised by a majority of the smaller fraction generally required for a quorum. (*Ibid.*)

<sup>256</sup> *Id.*, Ch. II, Table 2, p. 27.

<sup>257</sup> *Id.*, Ch. II, Tables 5, 6, 12, 13, 14, and 56, pp. 53, 56, 92, 95, 98, and 171, respectively.

accounted for aggregate assets<sup>258</sup> of about \$2,900,000,000, of the industry's total assets<sup>259</sup> of \$4,500,000,000. Thus, 5% of the total number of investment companies at the end of 1929 accounted for approximately 60% of the industry's aggregate assets, and this concentration of assets increased to about 64% at the end of 1936.

Because of the nature of the control of individual companies and of the concentration of a large proportion of the industry's assets in a comparatively few companies, the experience of the investor in the investment company industry as a whole is apparently in a large measure dependent upon the competence and integrity of a relatively few controlling individuals.

### C. Sales of and Trading in Investment Company Securities

The analysis of sales by investment companies of their own security issues indicates not only the extent of the participation by the public in these organizations but also the costs of administration which ultimately were borne by the public. From the inception of these organizations in this country to the end of 1936, these total sales, excluding intercompany transactions, totaled approximately \$7,000,000,000, of which \$500,000,000 are estimated sales prior to 1927.<sup>260</sup> During 1937 it is estimated that an additional \$200,000,000 was raised by sales of new investment company security issues.<sup>261</sup> The relative magnitude of this volume of sales can be gauged by the fact that for the entire period 1927-1936, this volume was equivalent to more than 20% of all nonrefunding corporate capital issues.<sup>262</sup>

The importance of intercompany sales of investment company securities—sales by one investment company of its own security issues to another investment company—is indicated by the fact that in closed-end management investment companies proper and management investment-holding companies such transactions amounted to slightly more than \$1,200,000,000 during the 1927-1935 period, while public offerings of such investment company securities during the same period amounted to \$2,242,000,000.<sup>263</sup>

Of the more than \$7,000,000,000 raised by the sale of security issues of investment trusts and investment companies for the period 1927 through 1935, between \$400,000,000 and \$500,000,000 was paid to underwriters, dealers, and salesmen in connection with the distribution of these securities.<sup>264</sup> The gross underwriting and distribution cost, on such basis, amounted to between 6% and 7% of gross proceeds. These figures not only show the level of cost to investors in connection with the raising of this capital, but also may partially explain the rapid formation of investment companies in this country, the distribution of

<sup>258</sup> *Ibid.*

<sup>259</sup> *Op. cit. supra*, note 256.

<sup>260</sup> For over-all statistics, see Pt. Two, Ch. III, pp. 183-6, and Table 59, p. 186 (House Doc. No. 70, 76th Cong.).

<sup>261</sup> Pt. Two, Ch. III, p. 179 (House Doc. No. 70, 76th Cong.).

<sup>262</sup> *Id.*, Table 59, p. 186. This percentage may vary somewhat, depending upon the statistics used to measure total security flotations.

<sup>263</sup> *Id.*, pp. 196-200, and Table 62, p. 198. These figures include companies in the Atlas and Equity groups.

<sup>264</sup> *Id.*, Ch. VII, pp. 503-6. The \$7,000,000,000 referred to here covers a different period from the \$7,000,000,000 referred to above, and includes several items not included in the figure referred to above. See also note 10, p. 506.

the securities of which constituted a substantial source of profit to their sponsors. In addition to this approximately one-half billion dollars paid by the public in the form of gross spread <sup>265</sup> to the underwriters and distributors, the sponsors also received in many cases, as compensation for distribution of investment company securities, without payment of cash or at prices less than those charged the public, options and warrants to subscribe to stock and other benefits.<sup>266</sup>

The relation of the volume of trading in investment company securities on security exchanges to the total volume of trading on these exchanges varied from year to year and for different exchanges. While during the 1927-1936 period the trading in investment company stock issues averaged about 5% of the total exchange volume in all stocks, it approximated 20% on the New York Curb Exchange for two years and was about 60% of the total volume on the Buffalo Stock Exchange for two years.<sup>267</sup>

Since security issues traded in the over-the-counter markets have not in the past been subject to supervision comparable to that of securities traded on exchanges,<sup>268</sup> it is significant that a greater proportion of the investment companies had all their issues traded off exchanges at the close of 1936 than was the case at the end of 1930.<sup>269</sup> By the end of 1936 the investment companies with issues traded only over-the-counter were almost four times as numerous as those with issues traded on stock exchanges.<sup>270</sup>

#### D. Portfolios of Investment Trusts and Investment Companies

At the end of 1936 a total of 558 investment trusts and investment companies had an investment in securities with an estimated market value of \$4,055,000,000, of which \$3,560,000,000, or 88%, consisted of common stocks, while the remainder was equally divided between preferred stocks and bonds.<sup>271</sup> Regardless of the capital structures of investment companies in this country (whether made up of one class of stock, or common stock with preferred stock, bonds, or debentures) practically all these companies have been substantially funds for investment in common stocks or equity securities.

It is estimated that at the end of 1936 approximately \$2,900,000,000 of the total of \$3,560,000,000 of common stocks in the portfolios of these companies were securities listed on the New York Stock Exchange and represented 51½% of the value of all common stocks listed on this exchange.<sup>272</sup> At the end of 1935 the aggregate investments of all investment trusts and companies in the common stocks of the 74 largest corporations listed on the New York Stock Exchange amounted to approximately 45% of their total security investments and constituted 71½% of the value of all outstanding shares of these issues.<sup>273</sup>

<sup>265</sup> The gross spread is the difference between the public offering price and the net proceeds received by the issuing company.

<sup>266</sup> Pt. Two, Ch. III, p. 203 (House Doc. No. 70, 76th Cong.).

<sup>267</sup> *Id.*, Ch. IV, p. 304.

<sup>268</sup> Securities traded on stock exchanges are not only subject to the rules of the exchanges but also to the disclosure and other provisions of the Securities Exchange Act of 1934.

<sup>269</sup> *Op. cit. supra*, note 267.

<sup>270</sup> *Ibid.*

<sup>271</sup> Pt. Two, Ch. VIII, p. 626 et seq. (House Doc. No. 70, 76th Cong.).

<sup>272</sup> *Ibid.*

<sup>273</sup> *Ibid.*

The average number of issues in the portfolios of individual investment trusts and companies at the end of 1935 was 72 for the management investment companies proper<sup>274</sup> and 28 for the large fixed and semifixed investment trusts.<sup>275</sup> About half of the investment-holding companies studied had less than seven issues in their portfolios,<sup>276</sup> and in the case of most of these investment-holding companies the greater part of the portfolio consisted of but a single issue.<sup>277</sup> Although all management investment companies proper had a total of about 3,000 different security issues in their combined portfolios at every year-end from 1929 to 1936,<sup>278</sup> the major portion of the aggregate invested funds was concentrated in a relatively small number of issues.<sup>279</sup> At the end of 1936, half the value of the combined portfolios of management investment companies proper was accounted for by only 61 different issues, as compared with a total of 77 issues at the end of 1929. This greater concentration at the end of 1936 was due in part to the increase in uniformity in the security holdings of individual investment companies.<sup>280</sup>

A large number of investment trusts and companies were specialized; that is, they restricted their investments entirely, or predominantly, to securities of a single industry. At the end of 1936, such companies numbered about one-fourth of all management investment companies proper, and the value of their portfolios amounted to almost 10% of the value of the portfolios of all the investment companies in this group.<sup>281</sup> Practically all the investment-holding companies were specialized companies.<sup>282</sup> Of the fixed and semifixed investment trusts, approximately 30% were restricted to investments within a single industry.<sup>283</sup>

### E. Performance

Among the principal claims made by sponsors, managers, and distributors of the securities of management investment companies was that these organizations afforded the investor a kind of specialized and expert management of investment which he was not qualified to undertake himself or could not individually afford to secure. One major emphasis in the sales literature of the investment company

<sup>274</sup> Pt. Two, Ch. VIII, pp. 542-5 (House Doc. No. 70, 76th Cong.). This figure covers 150 investment companies and does not include the companies in the Atlas and Equity groups.

<sup>275</sup> Id., pp. 608-9. This figure covers 45 fixed and semifixed investment trusts whose assets at some time exceeded \$500,000 during the period 1927-1935.

<sup>276</sup> Id., pp. 596-7, and note 86, p. 597. The number of companies studied was 35.

<sup>277</sup> Ibid. At the end of 1929, in one-half of the management investment companies proper (excluding the companies in the Atlas and Equity groups), a single issue made up more than 10.4% of the market value of the individual portfolios. At the end of 1935, a single issue accounted for more than 7.2% of the portfolios of these companies. (Pt. Two, Ch. VIII, pp. 546-9.)

<sup>278</sup> Id., pp. 572-3, and Table 175, p. 573. This does not include companies in the Atlas and Equity groups.

<sup>279</sup> Id., pp. 580-2, and pp. 610-12, and Table 179, p. 582. In the combined portfolios of a selected group of general diversified companies, as well as in the fixed and semifixed trusts, the concentration in a small number of issues was even more marked. (Ibid.)

<sup>280</sup> Id., pp. 580-3, and Table 179, p. 582. These figures cover 164 management investment companies proper for the 1936 year-end and 116 companies for the 1929 year-end.

<sup>281</sup> Id., pp. 536-8, and Table 162, p. 540. This does not include companies in the Atlas and Equity groups.

<sup>282</sup> Id., pp. 596-7.

<sup>283</sup> Id., pp. 615-16. This is based on a study of 214 fixed and semifixed trusts.

industry was upon the qualifications and expertness of the management of these investment companies.

Some indication of the validity of these claims, based upon past performance of management investment companies in this country, may be obtained by a comparison of the performance of management with the performance of a common stock index.<sup>284</sup> Over the period 1927–1937 as a whole (which represents almost the entire period of the importance of these organizations in this country, and which included years of rising and declining prices, and active and inactive security markets), no significant difference existed between the performance of these investment companies and that of the common stock index, although the performance of investment companies was slightly worse than the index during years of rising security prices and better than the index during periods of declining security prices.<sup>285</sup> For the period 1930–1935, a comparison of the experience of an individual who kept his funds on deposit in a savings bank, or in government or other high-grade bonds with the experience of an investor in a typical or average investment company indicates a more favorable experience for the former individual.<sup>286</sup> However, there is no indication of the extent to which the average individual investor in securities actually achieved a performance as good as the common stock index or typical investment company. In addition individual investment companies varied widely in their performance. For example, \$1.00 in net assets at January 1, 1930, in the best performing closed-end company of the group analyzed increased in value, with distributions reinvested annually, to \$1.26 at the end of 1937, while in the poorest performing company in this group, \$1.00 in net assets declined in value to 15¢ over the same period. These extremes may be compared with the average company in which \$1.00 in net assets at the beginning of the period was worth 76¢ at the end of the period.<sup>287</sup>

As the performance of these investment companies was substantially that of a common stock index—which may be regarded essentially as an unmanaged portfolio—it appears that the typical investment company over the past decade failed to meet the sometimes avowed objective of a performance surpassing such an index. The failure of investment companies to meet this criterion of performance—and it is recognized that it is not the only criterion which may be employed—is, of course, attributable to many factors and problems inherent in the management of investments. However, the record of public examinations amply demonstrates that the quality of the performance of the investment company industry as a whole was in no small measure adversely affected by the cumulative effect of the subordination of the interests of these organizations to the pecuniary interests of their controlling persons.

<sup>284</sup> The performance of management is measured by the performance of the managed fund as a whole without taking into account the costs of distribution paid by investors and is not measured by the experience of the holders of each of the different classes of securities outstanding. The index used is the Standard Statistics Company index of 90 common stocks.

<sup>285</sup> Pt. Two, Appendix J, pp. 904–6, and Supplement V, p. 933 et seq. (House Doc. 70, 76th Cong.).

<sup>286</sup> Id., Appendix J, p. 873.

<sup>287</sup> Id., Appendix J, Supplement V, p. 933 et seq.

## F. Investors' Experience

With respect to the preservation of the capital entrusted to all investment trusts and investment companies by the holders of every type of security issued throughout the period 1927-1935, the analysis indicates a substantial shrinkage.<sup>288</sup>

The net assets of investment trusts and companies at the beginning of 1927<sup>289</sup> aggregated almost \$900,000,000, while total capital raised up to the end of 1935 amounted to about \$7,900,000,000, which included more than \$7,000,000,000 from the sale of new issues of investment company securities in the period. Of this \$7,900,000,000 almost \$1,600,000,000 was returned to investors through the medium of repurchases by the investment companies of their own outstanding securities, thus reducing the total capital investment of the public, as at the end of 1935, to about \$6,300,000,000. However, the current market value of the net assets of the investment companies and investment trusts in existence at the end of 1935 amounted to only about \$3,400,000,000. Therefore investors as a group sustained a combined loss, realized and unrealized, as at the end of 1935 of over \$2,900,000,000, which represented a shrinkage in capital of more than one-third (37%) of the amount originally paid by investors for the securities of investment trusts and investment companies.<sup>290</sup> On the same basis, investors in management investment companies proper alone suffered a 44% loss, realized and unrealized, on their total investment.<sup>291</sup>

Interest and dividends received by the security holders of all investment trusts and companies from 1927 through 1935 aggregated nearly \$1,200,000,000, or less than 3% per annum on the average capital investment,<sup>292</sup> while investors in management investment companies proper received an average of less than 2% annually.<sup>293</sup> These payments represented a smaller return, on the average, than investors would have received from other types of investments, such as United States government bonds or diversified lists of bonds or stocks as represented in the usual indexes.

The gross ordinary income of management investment companies proper during the period January 1, 1927, to December 31, 1936, aggregated approximately \$440,000,000, of which 73% comprised dividends, and 23% interest.<sup>294</sup> Stated as a percentage of the average market value of total assets, gross ordinary yearly income ranged

<sup>288</sup> This statement and the figures in the following paragraph cover all the funds paid in by purchasers of all types of securities issued by these companies, including fees for distribution. The analysis did not attempt to consider separately the experience of the holders of each class of security or the experience of particular individuals who may each have been affected differently but was restricted to the determination of what happened to the total funds paid in by the combined group of investors.

<sup>289</sup> For the figures that follow, see Pt. Two, Ch. VII, pp. 503-6 (House Doc. No. 70, 76th Cong.).

<sup>290</sup> If allowance is made for interest and dividends received by holders of investment company securities, the net loss to investors is estimated to be about 22% of the total amount invested. (Pt. Two, Ch. VII, pp. 503-6 [House Doc. No. 70, 76th Cong.].)

<sup>291</sup> Pt. Two, Ch. VII, pp. 507-9 (House Doc. No. 70, 76th Cong.). This group includes the companies in the Atlas and Equity groups. With allowance for interest and dividends received, the combined net loss to all investors in management investment companies proper is estimated to be about 32% of their total investment. (Ibid.)

<sup>292</sup> Id., pp. 503-6.

<sup>293</sup> Id., pp. 507-9. This group includes the companies in the Atlas and Equity groups.

<sup>294</sup> Id., Ch. II, p. 78. The companies in the Atlas and Equity groups are not included here.



from 3¾% to about 5½% for the period 1930 to 1936.<sup>295</sup> Operating expenses absorbed about 20% of ordinary income over the period 1927-1936, while expenses for salaries and management fees accounted for more than 44% of the total operating expenses.<sup>296</sup>

#### IV. DEVELOPMENT OF PUBLIC CONSCIOUSNESS OF ABUSE

This section outlines briefly the extent and growth of the public expression of dissatisfaction with and criticism of investment trusts and investment companies in this country, particularly in published articles, reports of public agencies and financial associations, and editorial comment in the press. The material in this section is not submitted as proof of the existence of abuses or deficiencies in the industry.<sup>297</sup> Rather it is a reflection of the trend of public opinion concerning these organizations during various phases of their development in this country and an indication that this public opinion, including that of the more conservative elements of the public, has recognized the serious nature of the problems which must be met.

The nature and growth of the criticism of investment companies have been affected, to a large extent, by the course of the development of the industry. Material relating to investment trusts and investment companies published prior to 1929 was in the main promotional in character. Most of the material critical of investment trusts appeared in publications which did not have wide public circulation. Furthermore, continuously rising security prices, which were reflected in the performance of investment companies, and the general attitude of the investing public prior to the stock-market break in 1929 combined to lessen the force of adverse criticisms and to discredit their validity at a time when almost 70% of the total public investment in these companies was being made.<sup>298</sup> However, after October 1929, when investment company securities reflected the general decline in stock market prices and sold at substantial discounts from their asset values instead of at the premiums previously commanded, severe losses were experienced by the holders of these securities. Thereafter, criticism of these investment organizations increased substantially.

##### A. Prior to October 1929

While a substantial amount of published material relating to investment trusts and investment companies appeared during the years 1921 through 1929, most of these writings were of a promotional or semipromotional nature.<sup>299</sup> Since the period immediately preceding the stock-

<sup>295</sup> *Ibid.* Owing to the rapid inflow of new capital during 1927, 1928, and 1929, the average market value of total assets was not calculated for these years. (*Id.*, Ch. II, note 66.)

<sup>296</sup> Pt. Two, Ch. II, pp. 78-81 (House Doc. No. 70, 76th Cong.). These figures, of course, do not represent the total compensation to management interests, which also frequently received commissions on the distribution of securities, options, warrants, profit-sharing agreements, brokerage, and other forms of compensation not appearing as management expenses in the income accounts. (*Ibid.* and see discussion *supra*.)

<sup>297</sup> The subsequent chapters of this part of the report contain the evidence adduced by the Commission in its study as to these abuses and deficiencies.

<sup>298</sup> Pt. Two, Ch. III, pp. 183-6, and Table 59, p. 186 (House Doc. No. 70, 76th Cong.).

<sup>299</sup> See Pt. One, Ch. III, pp. 57-62 (House Doc. No. 707, 75th Cong.).



market decline of October 1929—particularly the years 1927–1928 and the early part of 1929 when the industry reached its maximum rate of growth—was one of rapidly rising security prices, the performance of investment companies reflected this stock-market boom. These investment organizations, therefore, were not in those years subjected to the influence of adverse business conditions or precipitous security market declines. As a consequence, whether attributable to the sense of security in which writers and economists had been lulled or otherwise, relatively little criticism was directed toward the potential weaknesses of the growing industry. However, some concern was manifested publicly with respect to the future in this country and the latent deficiencies and abuses of these investment organizations. As early as 1920 the necessity for careful and expert management as the requisite for the successful operation of investment companies was emphasized in an article in the Federal Reserve Bulletin,<sup>300</sup> which stated:

The fundamental principle of the investment trust is the distribution of risk by the investment of funds in the securities and bonds of a great number of enterprises, investment in any one security usually being limited to a fraction of the capital, say 10 percent. \* \* \* A company formed for the purpose of investment is in a position to investigate the financial condition of undertakings in which funds may profitably be invested. The officers of such a company developed the habit of forming dependable judgments of economic conditions in foreign countries and conditions of the investment market. \* \* \*

It goes without saying that no investment trust can be successful except under the most careful management and with the assurance of expert reports on all its holdings.

In 1922 the existence of the conflict of interests between the sponsors and managers of investment companies on the one hand and the investors on the other and the possible consequences of such conflicts were strongly indicated by a financial writer, who stated:<sup>301</sup>

In theory the investment company is in a position to render a valuable service to small investors by eliminating excessive risk from investment in securities; but in practice this theory seldom works out in such a way as to be entirely satisfactory. This is due, not to any inherent weakness of the investment principle, but merely to the fact that any type of ownership organization in business must be run by man, who is not infallible in his judgment of the future value of business undertakings. Another weakness militating against proper insurance of small investors who buy securities of investment companies lies in the fact that these companies are private undertakings usually operated by those who manage them, and who look first to their own private profit. This feature is emphasized by the extensive use of founders and managers shares which are usually held by those persons who were particularly interested in promoting such companies. Their stock is frequently guaranteed by a first claim to a fixed rate of dividend and on assets with right to share liberally in extra profits. This prospect of extra profit and security has led many managers of investment companies to put the capital into speculative securities, which as frequently as not prove unprofitable. For these reasons it is open to serious doubt whether the investment company really does render a service to modern industry that cannot as well be left to the individual investor. The latter is no better equipped to ascertain the value and stability of the securities issued by investment companies than of those issued by operating concerns. It would, in most cases, be much safer for him to invest in the stocks of the big, firmly established industrials and railways, or in government bonds.

So, too, as early as 1923 the officials of the New York Stock Exchange apparently were concerned with the absence of restrictions

<sup>300</sup> Federal Reserve Bulletin, Vol. 6, November 1920, The Investment Trust as a Channel for Investment Abroad, p. 1168.

<sup>301</sup> Stocker, Archibald H., *Business Ownership Organization*, 1922, p. 302.

upon the possible activities and investments of investment trusts, and these vehicles were characterized as "blind pools."<sup>302</sup>

On July 24, 1924, the New York Stock Exchange adopted a resolution to the effect that the association of members of the Exchange as organizers, managers, or otherwise with investment trusts which did not properly protect their investors' interests might be held by the Exchange to be an act detrimental to the interests of the Exchange and thereby render the members liable to disciplinary action.<sup>303</sup> In view of the subsequent growth of the investment company industry and the part of Exchange members in such growth, it is difficult to say that this resolution had any great practical effect, although it does indicate the early recognition by informed financial opinion of the possibility of abuse in this new investment vehicle.

Subsequently, in 1927, the National Association of Securities Commissioners, comprised of state officials charged with enforcement of security fraud statutes (Blue Sky laws) of the various states, adopted a resolution creating a committee on investment trusts to study and examine the subject.<sup>304</sup> The particular problem presented to the committee was to determine the characteristics of investment trusts so that the public interest could be protected without unduly disturbing companies which were relatively sound and well managed. After an extended period of study, the committee made its report in 1929, adopted by the association, which aimed at strengthening existing Blue Sky laws.<sup>305</sup>

As has been indicated, by 1928 the industry was growing rapidly and had assumed large proportions. In that year the Attorney General of the State of New York, through the Security Bureau, Department of Law, conducted a survey of investment trusts and made a report which discussed some abuses and recommended, among other things, that investment trusts organized under the laws of New York be required to incorporate under the banking laws and thus be made subject to the supervision of the state banking superintendent.<sup>306</sup> A bill for the regulation of investment trusts was introduced in 1928 in the legislature of the State of New York, but failed of enactment.<sup>307</sup>

Similar concern as to the future of investment trusts and investment companies in this country was manifested in February 1928 by Repre-

<sup>302</sup> A New York broker who later sponsored an investment company, testified at a public examination (testimony of Paul Shields, Public Examination, Chain Store Stocks, Inc., at 15653): "[I] remember when I first went to the [New York] Stock Exchange in 1923 to suggest one [an investment trust] to them and they had never heard of an investment trust at that time and they called it a blind pool. \* \* \*"

<sup>303</sup> See Pt. One, Ch. III, p. 63 (House Doc. No. 707, 75th Cong.).

<sup>304</sup> *The New York Times*, January 27, 1929, "New Code to Guide Investment Trusts," pp. N9 and N14.

<sup>305</sup> *Ibid.* The report included a code of ethics which provided among other things: "The personnel of the office and management should show a clear record of good business repute and should be men of integrity and investment experience. \* \* \* The officers, promoters, or managers should make an investment of their own funds sufficient to insure a personal interest in the proper conduct thereof."

The code further provided that there should be "A clear statement of any privilege accorded the incorporators, officers, or managers."

<sup>306</sup> Ottinger, Albert, Attorney General, "Investment Trusts—A survey of the Activities and Forms of Investment Trusts with Recommendation for Statutory Regulation by the New York State Department of Law (1927) and Supplementary Survey (1928). See *Keane's Manual of Investment Trusts*, 1928, p. 651 et seq., and p. 741.

<sup>307</sup> For a copy of the proposed bill, see *Keane's Manual of Investment Trusts*, 1928, p. 773.

sentative McFadden, of Pennsylvania, in a speech in the House of Representatives, in which he stated:<sup>308</sup>

\* \* \* My chief concern about our investment trusts is their future growth. Will our trusts protect the savings of our American investors, or will millions be lost through unsound management?

\* \* \* \* \*

it may be necessary to place investment trusts under the regulation and control of the Federal Reserve Board by amending the Federal Reserve Act.

On October 15, 1928, the investment companies committee of The Investment Bankers Association of America recommended to the association at its annual convention that a code of practice be formulated for investment companies, and accord was expressed with the report of the National Association of Securities Commissioners, referred to previously.<sup>309</sup>

Toward the close of 1928 the Commercial & Financial Chronicle, discussing the dangers in launching investment companies in periods of boom prices, stated:<sup>310</sup>

It is perhaps unfortunate that these investment companies have sprung up among us in a period of inflated credit and boom prices on the Exchange. For while they have a place in our financial affairs if properly conducted within limited areas of investing they must be affected by the conditions now environing the issuance of stocks and bonds, and they should be approached with caution by the investing public.

Prior to 1928, the New York Curb Exchange did not admit to full listing the securities of organizations which it regarded as investment trusts, although during 1927 and 1928 issues of some companies which are now generally regarded as investment companies or investment trusts were either fully listed or admitted to unlisted trading privileges. On November 14, 1928, the New York Curb Exchange designated a committee on investment trusts to consider applications for listing of shares of such organizations.<sup>311</sup> On April 29, 1929, the New York Curb Exchange adopted the recommendation of its committee and

<sup>308</sup> Congressional Record, February 29, 1928, pp. 3808-9. See also article discussing this speech, *Commercial & Financial Chronicle*, March 10, 1928, Vol. 126, p. 1448, and *Keane's Manual of Investment Trusts*, 1928, p. 597.

<sup>309</sup> Proceedings of the Seventeenth Annual Convention of The Investment Bankers Association of America, at Atlantic City, New Jersey, October 15-19, 1928 (Chicago, 1928), pp. 56, 85, and 87.

<sup>310</sup> *Commercial & Financial Chronicle*, December 15, 1928, "Investment [Trust] Companies," Vol. 15, p. 3301. The above comment appeared at a time when the American experience with investment companies was comparable to the British experience in 1889. This article may be compared with one entitled "The 'Boom' in Trust Companies" in the *Economist Weekly Commercial Times*, London, on April 6, 1889, p. 433, which stated: \* \* \* "although successful with the public, the companies have not in some cases been able to make a very favorable start in business for they have followed so fast upon each other's heels that they have experienced great difficulty in purchasing proper investments. \* \* \* Indeed so rapid has been the advance that it is stated several of the new trusts have been unable to effect purchases and are now rather doubtful as to the direction in which their money shall be invested."

An article in the same publication, on February 4, 1893, entitled "The Difficulties of The Trust Companies" (p. 131) sums up the same matter in the following language: "\* \* \* that those responsible for the management of these Trusts have based no inconsiderable part of their operations upon false principles with the inevitable result that after a more or less brief period of apparent prosperity, losses, and difficulties have arisen \* \* \*"

<sup>311</sup> Pt. Two, Ch. IV, pp. 288-9 (House Doc. No. 70, 76th Cong.).

admitted to unlisted trading privileges, securities of organizations recognized to be investment trusts.<sup>312</sup>

Apparently because of an increasing number of investment bankers and brokerage firms who, attracted by the profit possibilities in investment companies, became closely identified with such organizations, the New York Stock Exchange also undertook a study of the industry. As a result, on June 6, 1929, the Exchange promulgated its "Tentative Special Requirements for Listing Investment Trust Securities."<sup>313</sup> While limited in their scope, these requirements did, nevertheless, require a statement from the applicant company relating to such matters as duality of interest of officers and directors of such companies and a submission to the committee on stock listing of data relating to management contracts, excessive unfunded debt, commissions beyond those customary and reasonable, and the like.

These requirements laid down by the New York Stock Exchange were another manifestation of the awareness by the financial community of the susceptibility of this growing industry to abuses. However, the sphere of influence of the New York Stock Exchange was relatively limited because few investment trusts applied for listing.<sup>314</sup> Furthermore, the problem of adequate supervision by the Exchange, assuming that the jurisdiction of the Exchange extended to these organizations, was aggravated by the fact that many investment companies were sponsored by members and thus conflicts of interests may have permeated their transactions. While there were advantages accruing to investment companies by the listing of their securities on the New York Stock Exchange, yet the conditions in 1929 were of such a favorable nature as to permit sponsors to launch investment companies in the over-the-counter markets.

In an article in the *Atlantic Monthly* for March 1929,<sup>315</sup> a sponsor of an investment company, discussing the history of the early difficulties of the investment trust in England, predicted that, unless promoters in the United States avoided similar "errors and false principles, \* \* \* we [in the United States] shall inevitably go through a similar period of disaster and disgrace." In the opinion of the author, two major abuses were common: (1) Investment companies were being operated primarily to serve the self-interests of the sponsors rather than the best interests of shareholders; and (2) investment companies were being used as a depository for otherwise unmarketable securities. The author stated that he had testified before a committee of the New York Stock Exchange that the common general abuses of investment company promoters and managers could be traced to "dishonesty," "inattention," "inability," and "greed," and cited various illustrations of abuses in support of the points raised.

<sup>312</sup> *Ibid.* Among other conditions of listing, investment trusts were required to agree not to repurchase their securities at prices in excess of asset value and to publish certain specified information relating to their portfolios in annual reports to investors. (*Ibid.* and Appendix C, pp. 755-60.)

<sup>313</sup> Pt. Two (House Doc. No. 70, 76th Cong.) Ch. IV, pp. 287-8 and note 21, p. 288; see also Appendix D, p. 779 et seq.

<sup>314</sup> *Id.*, pp. 287-95.

<sup>315</sup> Cabot, Paul C., "The Investment Trust," *Atlantic Monthly*, March 1929, pp. 401-408. Mr. Cabot was an organizer and has been an officer of State Street Investment Corporation since its inception. He has been president since January 30, 1934. (Reply to the Commission's questionnaire for State Street Investment Corporation, Pt. VII.)

An investment banker, speaking in 1929 on the floor of the eighteenth annual convention of the Investment Bankers Association of America, pointed out some of the unsound purposes motivating the formation of investment companies as follows:<sup>316</sup>

I saw a pretty good example of it about two months ago. One of our Governors sent a man up from the south with a letter of introduction to me; the fellow wanted to form an investment trust. This Governor asked me if I could give him any slant on it. He said: "If I form an investment trust with this fellow, I do not know whether I am getting a wildcat by the tail, or not. I would like to have you tell me." The man came and talked to me about this thing and I said: "Just why do you want to form an investment trust?" He said: "My firm has been dependent entirely on other people's securities. We have not been able to get anybody else's securities, so one reason I want to form an investment trust is to manufacture securities to sell."

Now, that is a pretty dangerous slant. We may get a wildcat by the tail if we form an investment trust, and a real responsibility goes along with the sale of such securities. The responsibility does not pretend to cease when you sell the securities. If you are an individual, you are going to continue and you can't let go of it. You have got it and you have to hang on to it.

In an article in the *Magazine of Wall Street* for September 21, 1929, the author, among other things, stated:<sup>317</sup>

Management is a particularly important factor in investment companies because the assets of such companies are almost exclusively cash, call loans, and marketable securities, and because the business of such companies is the investment and reinvestment of these assets, shifting them as seems best from company to company and from industry to industry. Such assets are easily converted to personal enrichment by dishonest managers or can be easily, quickly, and secretly dissipated by incapable and reckless managers, just as they can be substantially increased in value for the investors' benefit by capable handling.

\*                    \*                    \*                    \*                    \*                    \*

\* \* \* An important point is the time and labor the managers expect to devote to the work of management. It may, or may not, be their major interest. Some light may be thrown on this question by the amount and proportion of their own permanent cash investment in the joint undertaking.

However, it is apparent that the critical comment upon investment trusts and investment companies during the period prior to October 1929, was not only sporadic but confined largely to expression before associations and in the financial periodicals. It is doubtful whether a very broad public consciousness of the possibility of abuse existed prior to the stock market collapse in October 1929.

## B. After the Market Collapse in October 1929

### 1. GENERAL EXPRESSIONS OF APPREHENSION AND DISAPPROVAL

After the sharp decline in security prices in October 1929, investment companies appeared in a particularly unfavorable light.<sup>318</sup> As the depression continued in the years following, investors became more receptive to critical discussion of investment companies. From the

<sup>316</sup> Dickey, Charles D., in "Proceedings of the Eighteenth Annual Convention of the Investment Bankers Association of America at Quebec, Canada, October 13-18, 1929" (Chicago, 1929), p. 203.

<sup>317</sup> Williams, Carl, "How to Select an Investment Trust," *Magazine of Wall Street*, September 21, 1929.

<sup>318</sup> See Sec. II, B, supra.

<sup>319</sup> *Fortune*, September 1935, p. 53.

perspective of 1935, one writer, referring to the investment companies organized in the latter part of the 1920 decade, stated: <sup>319</sup>

Many of them were really nothing but speculative pools operated for the benefit of their officers. \* \* \* There is no wonder that during the collapsing market of the next three years the public suspicion of Wall Street was focused as hard on the investment companies as on any part of the financial map. Their managements had rigged them for the rankest sort of speculative activity at a time when the whole scale of values was about to hit the skids. Result: public faith in the investment-company managements just about touched bottom and stocks of most of them actually dropped below the asset value behind the shares.

Discussing the possible developments of the relation between certain banking groups and investment companies, *The Literary Digest* on October 26, 1929, quoted the *New York Journal of Commerce* as follows: <sup>320</sup>

The close cooperation between various banking groups and certain investment trusts should deceive no one into supposing either that this connection is inevitable or that it has any logical relationship to plans for concentrating banking control through resort to holding companies. The interest of the investing public in these new developments is, furthermore, distinctly subordinate to that of the business and industrial community, which may eventually find that banking groups, joined through holding companies, and simultaneously controlling various hybrid or falsely named investment trusts, are in a position to exercise an extensive and rapidly growing influence over industrial policies.

Commenting on the rapid rate of propagation of the trading or finance type of investment company, an article in the *Commercial & Financial Chronicle* in December 1929, quoted from an article in the *American Bankers Association Journal* as follows: <sup>321</sup>

I may be doing an injustice to trading or finance corporations as a class, but seeing the constant birth of them—almost a daily litter, one might say—it has seemed as though they were conceived to meet a demand for a personally conducted tour of the small investor through the broad avenues and the by-paths of Wall Street. I doubt if they have a permanent place in the business of investing in securities or that they will survive the next prolonged period of declining prices. Consequently, I do not see how a damaging deflation of their common stocks can be avoided.

Although stock prices rebounded during the early months of 1930 and much optimism had been restored, an article in *Barron's* for February of that year raised the question of the soundness of investment companies <sup>322</sup> and made some comparisons between American and British experience. It was suggested that the industry would have to pass through a period of continued depression in order to make a sound appraisal possible.

In April 1930 the first of a series of weekly magazine articles appeared which reviewed critically the investment companies in this country and dealt in great detail with most of their defects and abuses known at that time. <sup>323</sup> The writer recalled Mr. Justice Brandeis' observation, <sup>324</sup> in summarizing the findings of the Pujo Committee, <sup>325</sup>

<sup>319</sup> *The Literary Digest*, October 26, 1929, p. 62.

<sup>321</sup> *Commercial & Financial Chronicle*, December 7, 1929, Vol. 129, p. 3529, quoting from an article by Charles F. Speare entitled "Investment Trusts and Others," *American Bankers Association Journal*, November 1929.

<sup>322</sup> "Are American Investment Trusts Sound?" *Barron's*, February 24, 1930, p. 11.

<sup>323</sup> Flynn, John T., "Investment Trusts Gone Wrong," *The New Republic*, April 2, 1930.

<sup>324</sup> Brandeis, Louis D., *Other People's Money and How the Bankers Use It*, 1914.

<sup>325</sup> Report of the committee appointed pursuant to House Resolutions 429 and 504 to investigate the concentration of control of money and credit, House Report No. 1593, 62d Congress, 3d session, Feb. 28, 1913.

that through very small investments in the common stocks of a few large insurance companies and banks, control was obtained over vast resources representing the total of many small contributions. The author pointed out that, by the use of the same technique, investment trust promoters had pyramided their control and projected their influence over large pools of wealth. Commenting on the lack of control by investors over management, the author stated:<sup>326</sup>

The stockholder in an investment trust is a self-confessed amateur. The manager is a self-proclaimed expert. \* \* \* But the participants in the trust ought to have the power to dismiss a faithless or incompetent management. This power they are deprived of by the manner of organization which puts the permanent ownership of the fund into the hands of the promoters who, thereafter, are at liberty to do with the fund precisely what they wish.

The articles, developing the concept of duality of interest and self-dealing by insiders in investment companies, charged that secrecy usually cloaked these dealings, which were characterized by the absence of arm's-length dealing, and stated "the right hand sells to the left." The article, emphasizing the aspect of control of investment companies, stated:<sup>327</sup>

The money of the masses of small investors will tend to be withdrawn from stocks and will move toward these pools and then the stocks will also move toward these pools because the money is there to acquire them. \* \* \* My object is to call attention to it and to stimulate action to arrest it or control it or direct it in the interest of the public \* \* \*.

Measures should be taken to prevent the control of the investment trust from falling into the hands of so-called insiders.

In the same year, 1930, an article in the *Harvard Law Review*, discussing the need of statutory regulation of investment trusts, stated:<sup>328</sup>

Owing to the immense stake of the public in the affairs of investment trusts, danger of mismanagement has become a matter of widespread concern, and evidences of abuse have given rise to demands for, and some attempts at, legislative correction.

The article further observed that shareholders of investment trusts, despite their growing dissatisfaction, were greatly hampered in the adequate enforcement of their rights in view of the limited remedies afforded by the common law, and that the successful prosecution of law suits, although affording relief in individual cases, was not effective to prevent the recurrence of abuses.

In April 1931, the New York Stock Exchange revised the "Tentative Established Requirements for Listing Investment Trusts" adopted on June 6, 1929, by enlarging requirements as to accounting methods and reports to stockholders.<sup>329</sup> While the Exchange stated that it was "too early to deal with the subject in anything like a comprehensive manner," the matters of reacquisition of previously issued securities, acquisition of securities of other investment trusts, dividend policies, and directorates were treated to some extent.

By this time a much broader section of the population, particularly the small investor, had become familiar with the investment trust

<sup>326</sup> Flynn, John T., *Investment Trusts Gone Wrong*, New York, 1931, p. 43. This book is, in part, a reprint of the articles published previously in *The New Republic*.

<sup>327</sup> *Id.*, at pp. 154, 155, 178.

<sup>328</sup> "Statutory Regulation of Investment Trusts," 44 *Harv. L. Rev.*, November 1930, pp. 117-20.

<sup>329</sup> Part Two, Ch. IV, Appendix E, p. 787 et seq. (House Doc. No. 70, 76th Cong.).



industry through the vigorous and successful promotion of the sales of the fixed and semifixed investment trust shares and to a smaller extent through the offering of installment investment contracts. On May 7, 1931, the New York Stock Exchange published a minute to the effect that it would interpose no objection to the association of its members with those fixed and semifixed investment trusts which were on the Exchange's so-called unobjectionable list—fixed trusts which met with certain specified requirements.<sup>330</sup>

## 2. STUDIES AND INVESTIGATIONS BY THE FEDERAL GOVERNMENT

As the depression deepened following the severe break in the stock-market prices in the fall of 1929, the Senate of the United States, on March 2, 1932, authorized and directed its Committee on Banking and Currency to make a thorough and complete investigation of stock-exchange practices.<sup>331</sup>

The report of the Committee, made on June 16, 1934, discussed in some detail investment trusts and investment companies in this country. Commenting on the absence of regulation of these organizations, the report stated:<sup>332</sup>

In the past decade investment trusts have assumed such proportions and magnitude as to become a vital factor in the financial structure of the Nation. Although bearing an essential similarity to banking, the organization, operation, and management of investment trusts have not been subject to comparable legal control; and apart from the application of the Securities Act of 1933 and the State "blue sky" laws to the sale of new issues, there has been no legal safeguard provided for the investing public.

Discussing the effect of this absence of regulation and of the conflicts of interest between management and the investing public, the report stated:<sup>333</sup>

This *laissez faire* policy nurtured a mushroom propagation of investment trusts of incalculable economic significance. The investment company became the instrumentality of financiers and industrialists to facilitate acquisition of concentrated control of the wealth and industries of the country. The investment trust was the vehicle employed by individuals to enhance their personal fortunes in violation of their trusteeship, to the financial detriment of the public. Conflicts of duty and interest existing between the managers of the investment trusts and the investing public were resolved against the investor. The consequences of the operations of these management trusts have been calamitous to the Nation.

The Committee found that investment trusts had been operated unsoundly and had been used to the detriment of investors for the

<sup>330</sup> A list of these requirements will be found in the supplemental report on fixed and semifixed investment trusts.

<sup>331</sup> S. Res. 84, 72d Congress. The resolution directed "a thorough and complete investigation of the practices with respect to the buying and selling and the borrowing and lending of listed securities upon the various stock exchanges, the values of such securities, and the effect of such practices upon interstate and foreign commerce, upon the operation of the national banking system and the Federal Reserve System, and upon the market for securities of the United States Government, and the desirability of the exercise of the taxing power of the United States with respect to any such securities." (See also Report of the Senate Committee on Banking and Currency on Stock Exchange Practices, 73d Congress, Senate Report No. 1455, 1934, p. 1.) The scope of the inquiry was broadened in certain respects by resolutions dated April 4, 1933 and June 8, 1933. (Id., at 2.)

<sup>332</sup> Report of the Senate Committee on Banking and Currency on Stock Exchange Practices, 73d Congress, Senate Report No. 1455 (1934) at p. 333.

<sup>333</sup> Ibid.



benefit of their controlling persons. The report sharply criticized the activities of these persons, as follows:<sup>334</sup>

A veritable epidemic of investment trusts afflicted the Nation. The conception \* \* \* of these professed skillful investing managers of the function of an investment trust was diametrically opposed to the British viewpoint. Our investment trusts, lacking the essential characteristics of the British companies, were founded in speculative desire and dedicated to capital appreciation rather than investment return. The investment trusts of this country, from their inception, degenerated into a convenient medium of the dominant persons to consummate transactions permeated with ulterior motives; served to facilitate the concentration of control of the public's money; enabled the organizers to realize incredible profits; camouflaged their real purpose to acquire control of equities in other companies; and became the receptacles into which the executive heads unloaded securities which they, or corporations in which they were interested, owned.

The report classified and discussed at length certain of the abuses which the inquiry disclosed had existed in the investment company field including concentration of control of the public's money,<sup>335</sup> excessive profits to organizers,<sup>336</sup> failure to diversify holdings,<sup>337</sup> "unloading" of securities on investment trusts,<sup>338</sup> and formation of investment companies for ulterior purposes.<sup>339</sup>

While this investigation of stock exchange practices was pending, the investigation of public utility holding companies<sup>340</sup> which was being conducted by the Federal Trade Commission,<sup>341</sup> pursuant to the direction on February 15, 1928, of the Senate of the United States, was nearing completion. As this investigation progressed the close similarity and relationship between public utility holding companies and certain types of investment companies became manifest.<sup>342</sup> As a consequence the Public Utility Holding Company Act of 1935, providing for the control and regulation of public utility holding companies, enacted August 26, 1935, contained a provision (Section 30) authorizing and directing the Securities and Exchange Commission to conduct the instant study of investment trusts and investment companies.<sup>343</sup>

As the study and investigation of investment trusts and investment companies have proceeded, the Commission has received a large number of letters from dissatisfied investors in the securities of certain of these organizations. Originating in all parts of the country, these letters

<sup>334</sup> Id., at 339.

<sup>335</sup> Id., at 339.

<sup>336</sup> Id., at 344.

<sup>337</sup> Id., at 348.

<sup>338</sup> Id., at 351.

<sup>339</sup> Id., at 359.

<sup>340</sup> Report of the Federal Trade Commission upon Utility Corporations, pursuant to S. Res. 83, 70th Congress, 1st Session, 1935, Doc. 92, Pt. 71A, pp. X, 209.

<sup>341</sup> S. Res. 83, 70th Congress, 1st Session.

<sup>342</sup> See also Pt. One, Ch. III, note 197, p. 70 (House Doc. No. 707, 75th Congress).

<sup>343</sup> August 26, 1935, c. 687, Title I; 49 Stat. 803; 15 U. S. C. Secs. 79-79z-6. See also Pt. One, Ch. I (House Doc. No. 707, pt. 1, 75th Cong.). The report of the Senate Committee on Interstate Commerce on the Public Utility Holding Company Act of 1935 (May 13, 1935, Report No. 621, Calendar No. 651, 74th Cong.) contained the following statement at pp. 10-11:

*"R. Study of investment companies.*—The committee has added a provision directing the Securities and Exchange Commission to make a study and report its recommendations to Congress concerning investment companies, the influence exerted by them upon companies in which they are interested, and the influence exerted upon their investment policies by interests affiliated with their management. This subject is closely allied with the present subject of holding company control and other problems of corporate finance related thereto."

of complaint indicate not only the wide extent of investor discontent but also the serious impact of these organizations upon many of their security holders. These letters range from general statements of dissatisfaction at severe losses incurred to specific complaints of various practices of the managers of some of these companies and of the distributors of their securities. Since these letters, which usually refer to specific companies and grievances, are not proof of the matters complained of, their contents are not here set forth.

Also during the course of the instant study, articles in various magazines of national circulation and other periodicals, and editorials in newspapers in all sections of the country have appeared as recent indications of the extent to which investment trusts and investment companies are affected with a substantial public interest and constitute a widespread recognition by another sector of informed public opinion of the serious nature of the problems to be met. A list of many of the newspaper editorials dealing with the subject of investment companies and published in all sections of the country since the instant study commenced is contained in Appendix A. A list of references to several hundred books, articles in magazines, or other literature on the subject of investment trusts and investment companies, or in connection therewith, is contained in the library of the Securities and Exchange Commission, Washington, D. C.



## Chapter II

# DETAILED HISTORIES OF VARIOUS INVESTMENT TRUSTS AND INVESTMENT COMPANIES

This chapter presents in detail the histories of a number of investment trusts and investment companies in order to illustrate the cumulative effect on these organizations of various practices which were prevalent, although not every company engaged in them. While the various combinations of practices existing in the individual companies discussed may not have been representative of the industry, a great many of the specific practices disclosed in this chapter were common to a number of companies and occurred frequently. Furthermore, the experience of the investors in these companies as a result of these practices, while not universal, was similar to the experience of investors in many other investment companies. The selection of these particular companies for presentation was made, not only to show the variety of abuses and deficiencies possible in the organization and operation of an individual company, but also to show their relation to different periods in the development of these investment institutions generally, to different types of sponsors (investment bankers, commercial banks, brokers, individual promoters, and holding companies), and to various geographical locations.

No attempt is made in this chapter to classify the various transactions outlined. The subsequent chapters of this part of the report will specifically enumerate and classify the abuses and deficiencies in connection with the organization and operation of investment trusts and investment companies and will contain, in addition to the examples set forth in this chapter, numerous other instances disclosed by the study of the various malpractices and weaknesses of these organizations. The method of presentation used in this chapter is to preface the detailed discussion of the history of an individual investment company with a brief recapitulation or summary of the essential facts.

## I. IROQUOIS SHARE CORPORATION

### A. Summary

Iroquois Share Corporation was organized in January 1929 by O'Brian, Potter & Stafford, a general brokerage and investment banking firm located in Buffalo, New York. Formation of the investment company was undertaken by the firm in the expectation of obtaining substantial profits from brokerage fees and the distribution of securities, and of deriving such other benefits as the investment company could bring to its sponsor.

Prior to the public offering of 100,000 shares of the investment company's securities, the sponsor issued to itself, gratis, option warrants valid for three years for the purchase of 50,000 shares of stock at less than the initial offering price to the public, the exercise of which, if the company were successful, would dilute for the benefit of the sponsor any appreciation in the asset value of the shares held by the public.

While the investment company was still completely in the hands of "dummy" directors, the sponsor executed with the investment company a management contract for a period of ten years, which contained an express authorization for self-dealing by the managers with the investment company although its charter did not authorize self-dealing transactions. The stockholders were never informed about this clause of the contract.

After the market break of 1929, O'Brian, Potter & Stafford, being pressed for cash, sold to the investment company an unfinished and virtually unrented office building which it was constructing in Buffalo, New York, for \$313,616, the full amount the firm had expended on the building up to that time. To pay for the purchase of this building the investment company was compelled to sell part of its marketable portfolio in a depressed market. Subsequently in 1932 Atlas Corporation, then in control of Iroquois Share Corporation, surrendered a deed of the property to the second mortgagee for a release from the obligation of the mortgage, and as a result the entire investment in this office building was lost.

Soon after the organization of the investment company the sponsor, in its capacity of manager, purchased for the investment company's portfolio securities which the sponsor had previously underwritten or in which it was otherwise interested in the amount of \$1,395,953, most of which were not listed on the New York Stock Exchange. On these securities a realized and unrealized loss of \$663,315, or approximately 50%, was sustained. If the loss on the building enterprise be added to these losses, the total percentage of loss in these transactions amounted to about 60% of cost. In contrast, the loss on the \$7,863,477 of "unrelated" securities, which were brought and sold by the company during its existence, was only \$1,188,779, or 15% of the purchase price.

In April 1931 an offer of exchange of shares was made by Atlas Corporation, which the original sponsors of Iroquois Share Corporation urged its stockholders to accept. The sponsor received from Atlas Corporation warrants having a cash value at the time exceeding \$50,000 in exchange for their Iroquois Share Corporation option warrants. In addition, Walter F. Stafford, a former partner in the sponsor firm who had succeeded it as manager of the investment company, received \$75,000 for the cancelation of his management contract.

The sponsors within the 27 months of their management benefited from their association with the investment company to the extent of \$653,000, while the assets of the investment company shrank in excess of \$2,000,000, or more than 55% of the net contributed capital of approximately \$3,500,000, largely through losses suffered on investments in which the sponsors were directly or indirectly interested.

## B. Organization

Iroquois Share Corporation was incorporated in New York on January 14, 1929, with an authorized capital of 250,000 shares, all of one class and all without par value. The sponsor of the corporation was the investment banking and brokerage firm of O'Brian, Potter & Stafford of Buffalo, New York.<sup>1</sup>

The creation of the investment company by O'Brian, Potter & Stafford was the result of the business relationships of the firm with various banks in western New York. It was claimed that prior to 1929 those banks had continually approached O'Brian, Potter & Stafford with the proposal that the firm should manage investment companies which the banks intended to sponsor as an investment medium for their depositors.<sup>2</sup> O'Brian, Potter & Stafford had refused to manage such companies because of the fact that most of the "share corporations" contemplated by the various banks were to be small in size. However, the firm feared, it was asserted, that if it failed to comply with the suggestion of its various bank clients, it would lose some of the brokerage and other business of these banks. Consequently, in January of 1929 the firm suggested to its bank clients

<sup>1</sup> Partners of the firm were members of the New York Stock Exchange and Buffalo Stock Exchange. (Public Examination, Iroquois Share Corporation, at 13931, 13962.)

<sup>2</sup> Id., at 13933.

that it would form and manage a single "share corporation" whose shares could be purchased by the depositors of its various bank clients. The assent of the banks to this suggestion of O'Brian, Potter & Stafford allegedly led to the formation of Iroquois Share Corporation.<sup>3</sup>

It was admitted that the firm of O'Brian, Potter & Stafford was not "unmindful" of the profits which might accrue to it from its contact with an investment company. In addition to preserving the firm's contacts with its bank clients, a connection with an investment company would ensure to the firm substantial brokerage commissions and a purchaser of securities underwritten or otherwise acquired by the firm. With respect to the monetary benefits which might flow directly from the investment company to its sponsors, Mr. Stafford testified:<sup>4</sup>

A. \* \* \* Of course, these trusts were organized as an adjunct to a business that meant additional brokerage, and it meant sources of distribution [of securities] from time to time \* \* \*. It meant additional business to our firm, besides doing a service to our banks.

\* \* \* \* \*

Q. In any event, O'Brian, Potter & Stafford was not unmindful of the fact that an investment trust could be a source of income to O'Brian, Potter & Stafford?

A. No, sir; we were not unmindful of that.

Q. The various sources of income being, of course, the brokerage business, isn't that so, and a possible customer of securities that were being underwritten or issued by the investment banking houses, isn't that so?

A. That is right.

Q. And also a possible source of business from corporations whose securities were in the portfolio of the investment trust, isn't that so?

A. Well, I don't think that affects us so much, but it may have slightly, Mr. Schenker.

The original board of directors of Iroquois Share Corporation consisted of twenty-five individuals all of whom were partners or employees of O'Brian, Potter & Stafford.<sup>5</sup>

<sup>3</sup> Walter S. Stafford, a partner of O'Brian, Potter & Stafford until July of 1931 and the president of Iroquois Share Corporation, described the origin of the investment company as follows (id., at 13933):

A. \* \* \* there were discussions among the banks of western New York, with whom we had been doing business. At that time investment trusts were very popular and everybody wanted an investment trust, and there were some of the small banks in our territory organizing these investment trusts. They wanted to organize them and they came to us and wanted us to manage their investment trusts. We didn't like the idea of having numerous small trusts. These individuals were small country banks and we declined to do it, but a number of them went ahead and did it anyway and we thought we were losing contacts with our country banks as a result, and we had more or less discussions among ourselves as to the dangers of losing contacts with our bank customers.

Naturally we didn't like that situation, and then two or three other banks came in at approximately the same time with the proposal that we organize these little trusts, and we suggested at that time the possibility of organizing a larger trust and taking in these banks. That met with the approval of our banks and we organized Iroquois Share as a result of that.

<sup>4</sup> Op. cit. supra, note 1, at 13933-5. See also id., at 13961-9.

<sup>5</sup> Id., at 13939. The law firm of Slee, O'Brian, Hellings & Ulsh was engaged to attend to the legal matters in connection with the investment company. (Id., Commission's Exhibit No. 1394.) John Lord O'Brian, a member of the law firm, was a brother of Roland L. O'Brian, a partner of O'Brian, Potter & Stafford. (Derived from supplementary information supplied the Commission for Iroquois Share Corporation.) He was also a member of the first board of directors which succeeded the original "dummy" board. (Id., Commission's Exhibit No. 1395.). In a letter addressed to the Commission by Mr. O'Brian under date of March 31, 1937, Mr. O'Brian stated in part:

I was elected a director of the Iroquois Share Corporation about the middle of February 1929, and was a member of that board for only four months.

On deciding to accept a Presidential appointment as of June 13, 1929, I resigned and withdrew from my law firm early in June and at the same time, orally, confirmed later in writing, resigned both as director of Iroquois Share Corporation and the Title and Mortgage Guarantee Company. The July minutes should show the election of Mr. Hellings as my successor.

### C. Distribution of Securities

The investment company raised \$2,000,000 of contributed capital as a result of a first issue of 100,000 shares at \$20 per share.<sup>6</sup> However, a second issue of 33,334 shares at \$32.50 per share was offered in July 1929, the holder of every three shares of Iroquois Share Corporation stock being permitted to purchase one new share at \$32.50.<sup>7</sup> As a result \$1,083,355 was contributed as additional capital.<sup>8</sup> In April 1930 there was an exchange of 29,418.2 shares of Iroquois Share Corporation for all the shares of Williamsville Share Corporation, another investment company, resulting in additional capital of \$624,339.<sup>9</sup> The total contributed capital of Iroquois Share Corporation approximated \$3,707,694.<sup>10</sup>

Following the public sale of the investment company's securities, all of the "dummy" directors resigned and were replaced for the most part by officers and directors of banks doing business in Buffalo and vicinity. Among them were the presidents of eleven western New York banks and the cashiers of two others.<sup>11</sup>

The bank officers who were placed upon the board of directors of the investment company not only served to cement friendly and profitable relations between the institutions they represented and the firm of O'Brian, Potter & Stafford, but they acted as valuable conduits for the distribution of stock of Iroquois Share Corporation to the depositors of these small outlying banks.<sup>12</sup>

John T. Symes, the president of Niagara County National Bank & Trust Company, of Lockport, New York, and a director of Iroquois Share Corporation, in a letter dated July 23, 1929, to Walter F. Stafford, president of the investment company, stated: <sup>13</sup>

To me it is a very interesting association. I appreciate meeting you people from time to time. Just what I can do to reciprocate is a rather serious problem. Rather frequently I do get a chance to speak a word for Mr. Jelley's offerings, for I can without any reservation recommend the house that is back of them. Quite a lot of Iroquois Share is held in our locality. We have put a number of our customers into it and they are highly pleased.

<sup>6</sup> Op. cit. supra, note 1, at 13944. The public actually invested \$2,150,000 in these shares, of which the investment company received \$2,000,000 and O'Brian, Potter & Stafford retained \$150,000 as gross underwriting commissions. See *infra*, Sec. I. F. p. 73 et seq.

<sup>7</sup> During the week ending July 3, 1929, the price of Iroquois Share Corporation on the Buffalo Stock Exchange ranged between \$42 and \$49 per share. It reached a peak of \$50.50 on August 31, 1929. (Op. cit. supra, note 1, at 13960.)

<sup>8</sup> Op. cit. supra, note 1, at 13944-5.

<sup>9</sup> Id. at 13945-6 and discussed *infra*, p. 68.

<sup>10</sup> Id., at 13946 and Commission's Exhibit No. 1422.

<sup>11</sup> Id., Commission's Exhibit No. 1395. The board of directors of Iroquois Share Corporation included Franklin Bard, president of the Bank of Gowanda and of the Bank of Akron; H. G. Britting, president of the Bank of Williamsville; Nelson Cheney, president of the Bank of Eden; A. P. Chessman, president of the National Bank of Fredonia; Joseph P. Fell and George A. Keller, directors of the Marine Trust Company of Buffalo; George E. Merrill, president of the Erie County Trust Company; Richard S. Persons, president of the Bank of East Aurora; and Brewer D. Phillips, president of the Bank of Jamestown. (Ibid.) All these institutions are located in communities in western New York.

<sup>12</sup> Op. cit. supra, note 1, Commission's Exhibits Nos. 1391-2. It seems that substantial amounts of Iroquois Share Corporation stock were sold to members of Buffalo's large foreign population. (Id. at 13941-2.) At the time of the exchange for Atlas Corporation stock the executive committee of Iroquois Share Corporation also authorized advertisements in a daily Polish newspaper. (Derived from supplementary information supplied the Commission for Iroquois Share Corporation.)

<sup>13</sup> Op. cit. supra, note 1, Commission's Exhibit No. 1391.

On October 15, 1929, Mr. Symes again wrote to Mr. Stafford: <sup>14</sup>

I count myself highly honored in being permitted to sit with you occasionally. I am aware it is wholly a compliment because I do not know of anything I can do to reciprocate. It has been our pleasure, however, to include Iroquois Share Corporation in our suggestions to investors. It has been the pleasure of our Purchasing Department to place quite a number of orders, considering the size of our community.

All the important executive officials of the investment company were associated with the firm of O'Brian Potter & Stafford. Roland Lord O'Brian was chairman of the board of directors; Walter F. Stafford was president; Roger C. Adams, an employee of the firm, was executive vice president; Carl W. Wenger, a partner in the firm, was treasurer; and Nathaniel P. Hall, another partner, was secretary. In addition, Roland Lord O'Brian, Walter F. Stafford, and Frederick C. Stevens, of O'Brian, Potter & Stafford, were three of the five members of the investment company's executive committee,<sup>15</sup> upon which the bylaws conferred all the powers of the board of directors during the intervals between meetings of the board.<sup>16</sup>

### D. Management Activities

Under a management contract, approved by the "dummy" board of directors on January 23, 1929,<sup>17</sup> the sponsor gave itself the assignable right or option for three years from January 23, 1929 to buy from the investment company from time to time and in such lots as it might elect 50,000 shares of the capital stock of the investment company at \$20 per share. The initial public offering of stock was priced at \$21.50 per share. The stock immediately sold on the market at a premium of 3½ to 6 points and continued its upward climb until it reached a high of \$50.50 on August 31, 1929.<sup>18</sup>

Since there was no limitation on the right of the management to dispose of the options at any time, they did not serve even to provide a continuing incentive to the management. This was conceded by Mr. Stafford: <sup>19</sup>

Q. \* \* \* According to the management agreement you got those option warrants as part of the compensation for the management of the company, isn't that so?

A. That is correct; \* \* \*.

Q. There was no limitation upon your right to dispose of these option warrants, was there?

A. No, sir; they were ours outright.

Q! And if you saw fit to dispose of the option warrants the day that the stock opened up, according to your recollection, at 25 to 28, nobody could prevent you from doing it: isn't that so?

A. That is correct.

<sup>14</sup> Id., Commission's Exhibit No. 1392.

In addition to the foregoing letter from Mr. Symes, from which it is evident that the banks cooperated with the investment company organizers to secure public investment in the trust, Mr. Stafford testified (id., at 13941):

Q. Now, did you avail yourself of the facilities of the various banks which asked you to organize?

A. Yes, there were subscriptions that came in through the various banks.

<sup>15</sup> Op. cit. supra, note 1, Commission's Exhibit No. 1390.

<sup>16</sup> Id., at 15.

<sup>17</sup> See discussion, infra, p. 58.

<sup>18</sup> Op. cit. supra, note 1, at 13957-60.

<sup>19</sup> Id., at 13958-9.



Q. And then the situation would be that the very thing that was given to you as part compensation, at least, to manage the fund, you no longer possessed but had availed yourself of the profit on that; isn't that so?

A. That could have been done; that is correct.

Q. You have [heard of] cases, Mr. Stafford, have you not, where management stock is given as compensation for the management, and the managers sell their stock, and therefore they have no more pecuniary interest in the success of the trust; isn't that so?

A. That is right.

Q. And to some extent that element was present here, if you saw fit to dispose of your option warrants; isn't that so?

A. That is correct.

In the event that the operations of the investment company were unsuccessful the sponsor, of course, would not exercise its option and subscribe to any stock; whereas, if the asset value at any time during the three-year option period exceeded \$20 per share, the amount required to be paid per share by the sponsor, it could participate to the extent of one-third of this increase, through the exercise of these options. Accordingly, any enhancement in the equity of the stockholders was, during the life of the options, subject to dilution through their exercise by the management, as Mr. Stafford conceded:<sup>20</sup>

Q. At the time that you [were given] your 50,000 option warrants, there were only 100,000 shares issued?

A. Yes, sir.

Q. So that O'Brian, Potter & Stafford were always in a position to dilute the equity of the stockholders 33⅓, if the corporation was making money?

A. It might work out that way.

\* \* \* \* \*

Q. So that O'Brian, Potter & Stafford, by virtue of their option warrants, were in a position to participate in the subsequent earnings of the company, if the company was a success; isn't that so?

A. That was the purpose of the warrants, Mr. Schenker.

The option warrants, had they been exercised at \$20 per share for 50,000 shares when the market for the shares was at the high of \$50.50 per share, would have resulted in a profit to the sponsor of over \$1,500,000.<sup>21</sup> Mr. Stafford testified:<sup>22</sup>

Q. You then had those option warrants which, if you saw fit to exercise \* \* \* would have given you on that one item alone \$875,000; and if you did it on the basis of \$50 a share you would have over a million and a half?

A. That was—it doesn't seem possible today.

Q. Do you think a situation like that ought to be tolerated?

A. Tolerated?

Q. Yes.

A. I don't like that word.

Q. Continued, then?

A. I think there are a great many things that should be changed; yes, sir.

The sponsor never saw fit to exercise its options, but ultimately received in exchange Atlas Corporation warrants on the subsequent sale of the investment company to Atlas Corporation.<sup>23</sup>

## 1. MANAGEMENT CONTRACT

On January 23, 1929, the board of directors approved a contract<sup>24</sup> between the investment company and O'Brian, Potter & Stafford,

<sup>20</sup> Id., at 13951-2.

<sup>21</sup> Id., at 13960-1.

<sup>22</sup> Id., at 13961.

<sup>23</sup> See discussion *infra*, p. 73 et seq.

<sup>24</sup> Op. cit. *supra*, note 1, Commission's Exhibit No. 1393.

under the terms of which O'Brian, Potter & Stafford became the manager of the investment company for a period of ten years at an annual fee of one-half of 1% of its net worth. No provision was made which would permit the investment company to terminate the arrangement prior to the expiration date.

This management compensation to the firm of O'Brian, Potter & Stafford was in addition to the three-year option warrants to purchase 50,000 of the company's shares at \$20 per share. Thus, irrespective of the success of the sponsor's management, O'Brian, Potter & Stafford was assured of a management fee for a period of ten years and, in addition, could further participate in the profits, if any, by exercising its option warrants. Further, as was admitted by Mr. Stafford, president of the company, the investment company could not free itself from its sponsor's control during the 10-year management period without coming to terms with the sponsor.<sup>25</sup>

Moreover, although there was no provision in the certificate of incorporation permitting "self-dealing", i. e., direct transactions in which the sponsor was pecuniarily interested, between the sponsor and the investment company, the management contract contained a broad provision allowing the sponsor to deal with the investment company in any manner, provided the sponsor accepted "the responsibility of the fairness to the corporation of any such transaction." Paragraph 5 of the management agreement provided as follows:<sup>26</sup>

In the management of the funds and investments of the Corporation, the Managers may deal on behalf of the Corporation with themselves or with any of them or with any of their agents or employees or with any corporation, association, partnership, firm, trustee, syndicate, or individual in which they or any of them may be interested, and, specifically, but without limitation of the generality of the foregoing, may purchase securities from or sell securities to or otherwise deal in respect of securities with themselves or with any of them or with their employees or agents or with any corporation, association, partnership, firm, trustee, syndicate, or individual in which they or any of them may be interested; no such transaction shall be void or voidable by reason of any interest of the Managers therein; neither the Managers nor any of them nor any of their agents or employees nor any corporation, association, partnership, firm, trustee, syndicate, or individual shall be liable to the Corporation or to the stockholders thereof with respect to any profits which they may make in connection with any such transaction or otherwise; provided that the Managers agree to accept the responsibility of the fairness to the Corporation of any such transaction.

The prospective investor in the investor company was not informed of any intention to vest in the officers, directors, or manager the power to deal with the investment company on their own behalf. Mr. Stafford testified:<sup>27</sup>

Q. Don't you think that matter of self-dealing was of sufficient consequence that the prospective stockholder should have been apprised of the fact that the partners would have that right so that a person could determine whether he wants to be a participant in such a fund?

A. I think that in the light of present-day conditions, that certainly that would be a pertinent thing.

Mr. Stafford conceded that, by failing to include the "self-dealing" provision in the articles of incorporation and by making them part of the management contract, not only was the public not apprised of

<sup>25</sup> Id., at 13951-2.

<sup>26</sup> Op. cit. supra, note 1, Commission's Exhibit No. 1393.

<sup>27</sup> Id., at 13956-7.

the existence of this provision but the prospective investor could not ascertain its existence.<sup>28</sup>

Q. I [have] read the articles of incorporation very carefully, Mr. Stafford, and I find that no similar provision is included in the articles of incorporation. Now, the articles of incorporation, of course, would be a matter of \* \* \* public [record] \* \* \* isn't that so [since it would] \* \* \* have to be filed with the [County] Clerk?

A. Yes, sir.

Q. And the persons [financially] interested could ascertain what the rights of O'Brian, Potter & Stafford are in connection with dealing with the trust; isn't that so?

A. Yes, sir.

Q. But this management contract was not \* \* \* a public document, isn't that so?

A. That is right.

On January 23, 1929, within ten days after the certificate of incorporation was filed, Walter F. Stafford as president of the company signed the management contract on behalf of Iroquois Share Corporation. O'Brian, Potter & Stafford, as the other party to the agreement, executed the contract through its partner, Lars S. Potter.<sup>29</sup>

On the same day, January 23, 1929, a special meeting of the "dummy" board of directors was held at which the management contract with O'Brian, Potter & Stafford was ratified. Mr. Stafford testified:<sup>30</sup>

Q. \* \* \* [the management] contract was never submitted to the stockholders for approval, isn't that so?

A. I believe it was submitted to the Board, as was afterwards constituted, and that is my recollection, and approved by the permanent Board.

Q. I haven't seen that minute and I would be glad to give you a copy of the entire minutes to find that. The fact is that the Board that did ratify it was a Board constituted of the employees [of the firm of O'Brian, Potter & Stafford] and the partners?

A. That is true.

At the same meeting on January 23, 1929, the board of directors agreed to deliver to O'Brian, Potter & Stafford 100,000 shares of the company's stock against payment of \$20 a share. O'Brian, Potter & Stafford offered these 100,000 shares to the public at \$21.50 a share.<sup>31</sup> This offering was to make available the sum of \$2,000,000 to the investment company, and O'Brian, Potter & Stafford was to receive \$150,000 as a gross underwriting commission. As to the commission, Mr. Stafford testified:<sup>32</sup>

Q. \* \* \* Now, at the time that this resolution was adopted or the underwriting arrangement made, the board of directors of Iroquois Share Corporation was composed solely and wholly of partners of O'Brian, Potter & Stafford and employees, isn't that so?

A. That was the organizing board; yes, sir.

Q. So that this arrangement whereby O'Brian, Potter & Stafford got a gross underwriting commission of \$1.50 a share \* \* \* was literally fixed by O'Brian, Potter & Stafford, isn't that so?

A. That is correct.

<sup>28</sup> Id., at 13953-6.

<sup>29</sup> Id., Commission's Exhibit No. 1393.

<sup>30</sup> Id., at 13952.

<sup>31</sup> Id., at 13954 and Commission's Exhibit No. 1394. The issue was oversubscribed. (Id., at 13941.) The stock opened on the Buffalo Stock Exchange at a premium of 3½ to 6 points above the offering price. (Id., at 13957.) Mr. Stafford considered this a flattering evaluation by the public of the management's worth. (Derived from supplementary information supplied the Commission for Iroquois Share Corporation.)

<sup>32</sup> Op. cit. supra, note 1, at 13939.

Q. There was nobody representing the future stockholders when that commission was fixed, isn't that so?

A. Couldn't have been very well, Mr. Schenker.

Q. \* \* \* The sponsors sit [on both sides of] the table and they fix what in their judgment they think they ought to get paid?

A. That is correct, in a company of that kind.

## 2. PORTFOLIO INVESTMENTS

Investments by Iroquois Share Corporation, during the period of management by O'Brian, Potter & Stafford and later by Walter F. Stafford, were made in substantial amounts in securities of companies for which the firm of O'Brian, Potter & Stafford was the banker or of which members of the firm were directors or officers or with which other Iroquois Share Corporation directors had connections.<sup>33</sup> Most of these securities were not listed on the New York Stock Exchange.<sup>34</sup> The investment company's funds were expended to acquire large interests in small banks in western New York, investments which tended to advance the personal interests of the sponsors, since the firm was interested in procuring clients for the purchase of securities underwritten or sponsored by it. Investments of such character totaled \$1,395,953.88. A realized and unrealized loss of \$666,315.97 was sustained in these investments, exclusive of the loss sustained on the investment in a building erected by Seventeen Court Street, Inc., which will be described later.

In the case of companies in which the sponsor was personally interested, so-called related companies, the loss was 58%,<sup>35</sup> while investments in unrelated companies showed a loss of only 13%.<sup>36</sup> Never-

<sup>33</sup> A seat on the Buffalo Stock Exchange was purchased by the investment company for \$25,000. Despite the fact that the investment company paid the full price for this seat, it received only 60% of the commissions earned, while O'Brian, Potter & Stafford received the balance of the commissions. Mr. Stafford explained that that was the purpose of the purchase (id., at 13962) :

Q. After the trust bought its seat on the Buffalo Stock Exchange, then O'Brian, Potter & Stafford cleared —?

A. Yes, sir.

Q. And it retained 40% of the commissions and the trust got 60%, but you still participated in the brokerage?

A. That was the purpose of buying the seat on the Buffalo Stock Exchange.

The investment company traded actively in its portfolio securities, and O'Brian, Potter & Stafford received \$29,000 as brokerage commissions during the 27-month period of the sponsor's management. (Id. at 13962.)

<sup>34</sup> Id., at 14062-3. When Iroquois Share Corporation was organized, one of its first acts was to lend the sponsor, O'Brian, Potter & Stafford, \$1,780,879.70 on call, virtually all the money the investment company had at the time. Thereafter, for a short period this loan became under-collateralized by \$64,782.78. Subsequently the loan was paid in full. (Id., at 14105-7.)

<sup>35</sup> On portfolio investments alone in related companies the loss was over 47%. (Id., Commission's Exhibit No. 1415.) With the addition of the loss suffered on Seventeen Court Street, Inc., following the conversion of Iroquois Share Corporation stock into Atlas Corporation stock, the total loss was \$1,040,375, out of a total investment in related companies of \$1,779,625, or 58%. (Id., Commission's Exhibit No. 1422 A and B.)

<sup>36</sup> The loss on portfolio securities in unrelated companies was computed as follows: Total purchases of securities throughout the life of the investment company amounted to \$10,409,251, (id., Commission's Exhibit No. 1422-D) of which \$1,395,954 were in related companies, leaving a balance of \$9,013,297 in unrelated companies. The net loss on securities throughout the life of the corporation was \$1,855,095 (id., Commission's Exhibit No. 1422-B), of which \$666,316 was on securities in related companies, leaving a loss of \$1,188,779 on securities in unrelated companies, or 13% on the total of \$9,013,297.

theless, as has been pointed out, the investors were not even apprised of the existence of the power of self-dealing on the part of the management.

### 3. INVESTMENT IN SEVENTEEN COURT STREET, INC.

One of the largest losses suffered by the investment company was occasioned by the purchase on July 18, 1930 of the entire capital stock (1,000 shares) of Seventeen Court Street, Inc. from O'Brian, Potter & Stafford. In March 1928 that firm exercised an option it held to purchase land at Seventeen Court Street, Buffalo, New York. On this land O'Brian, Potter & Stafford contemplated erecting a seven-story office building in which the firm intended to occupy two floors and lease the others. The firm procured a building loan from the Marine Trust Company and a second mortgage loan from the Mutual Benefit Life Insurance Company.<sup>37</sup> The balance of the money necessary to erect the building was to be furnished by the partners of the firm. Construction of the building was started towards the end of 1929.<sup>38</sup>

Early in 1930 it became necessary for the firm of O'Brian, Potter & Stafford as a member of the New York Stock Exchange to attain a more liquid financial condition. Roland Lord O'Brian, a partner of the firm, testified that "we were required to keep liquid in order to protect our customers and our accounts and we did keep liquid."<sup>39</sup> Among the illiquid assets of O'Brian, Potter & Stafford was the stock of Seventeen Court Street, Inc.

Following the collapse in security values in October of 1929, real estate values also began to decline. As early as January 29, 1930, the firm of O'Brian, Potter & Stafford realized the difficulty of renting space in an uncompleted office building and were aware of the fact that a "building slump" had occurred in Buffalo. On January 29, 1930, Frederick C. Stevens, a partner in the firm of O'Brian, Potter & Stafford, wrote a letter to this effect to Walter F. Stafford, another of the firm's partners. Mr. O'Brian testified as to this letter:<sup>40</sup>

Q. I made the suggestion this morning that we pick out the best real estate brokers in Buffalo and have them start on the leasing of our new building. I think by good advertising in the newspapers, giving a typical floor plan, and also the street plan, showing the location of other buildings, that we can stimulate a good deal of interest and have the building partly rented at least before it is completed. This in turn would make financing the building very much simpler if we had some real contracts signed.

I have also suggested that we ought to designate a building committee to sit with the architects in letting all subcontracts. In this building slump I understand that many contractors are tickled to death to take contracts with a small margin of profit to keep them occupied. We should benefit by this situation.

That is an indication in Mr. Stevens' mind at least that there was a building slump in Buffalo, and you don't really deny that?

A. I don't deny that at all.

Q. This is January 29, 1930, which is approximately six months before the building was sold to the Iroquois Share Corporation, and certainly real-estate conditions became progressively worse after that, and not better, isn't that so?

<sup>37</sup> Id., at 13975, and Commission's Exhibit No. 1402.

<sup>38</sup> Id., at 13974-6.

<sup>39</sup> Id., at 13976.

<sup>40</sup> Id., at 13981-2 and Commission's Exhibit No. 1396.

A. I think that they probably did, but there was no slump in real estate that I can remember.

Q. At least, Mr. Stevens says that there was a building slump.

A. A building slump; yes.

By July of 1930 the building owned by Seventeen Court Street, Inc. was not yet completed. The only leases for space in the building which had been made were a lease with the firm of O'Brian, Potter & Stafford for the basement and the first floor of the building and a lease for space to be used for a cigar stand in the lobby of the building.<sup>41</sup> Six of the seven floors in the building were unrented.

From March 1, 1928, to July 3, 1930, the total investment by O'Brian, Potter & Stafford in Seventeen Court Street, Inc. amounted to \$313,616.32.<sup>42</sup> This cost represented the capital expenditures involved in the development of the real property and also included a net operating loss of \$35,168 incurred by the corporation prior to the construction of the building.<sup>43</sup>

In order to increase its own cash position, O'Brian, Potter & Stafford arranged to dispose of the stock of Seventeen Court Street, Inc. to Iroquois Share Corporation. As has been pointed out, the management contract of January 23, 1929, between Iroquois Share Corporation and O'Brian, Potter & Stafford expressly permitted the firm to deal with the investment company, provided the firm accepted the responsibility for the fairness of the transaction.

On July 18, 1930, O'Brian, Potter & Stafford offered to transfer all the stock of Seventeen Court Street, Inc. to Iroquois Share Corporation at a price equivalent to the full cost of the building enterprise, namely, \$313,616.32.<sup>44</sup> As part of the same transaction and as further consideration for the purchase of the Seventeen Court Street, Inc. stock, O'Brian, Potter & Stafford offered to cancel its management contract of January 27, 1929 with Iroquois Share Corporation. The firm, however, did not offer to surrender to the investment company the 50,000 Iroquois Share Corporation warrants which were granted pursuant to the terms of the management contract as additional compensation for its management services.

On the day it was made, the offer of O'Brian, Potter & Stafford to sell all the stock of Seventeen Court Street, Inc. was accepted by the board of directors of the investment company. The directors connected with the firm refrained from voting, and immediately upon acceptance of the offer all the directors and officials appointed through the firm of O'Brian, Potter & Stafford, with the exception of Walter F. Stafford, resigned. Mr. Stafford, on the other hand, as part of the transaction involving the sale of the building to the investment company, terminated his association with the firm of O'Brian, Potter & Stafford.<sup>45</sup> However, in accordance with a prearranged plan, he was

<sup>41</sup> Id., at 13991.

<sup>42</sup> Id., Commission's Exhibit No. 1400.

<sup>43</sup> Ibid.

<sup>44</sup> The corporation's equity in the building was subject to first and second mortgages totaling \$827,000. (Id., at 13980.) The partners of O'Brian, Potter & Stafford were all personally on the bond of the second mortgage, amounting to \$377,000, and in case of foreclosure with a resulting deficiency judgment, not only would their equity have been wiped out but the partners would also have been jointly and severally liable for the amount of any deficiency judgment. (Id., at 13980.)

<sup>45</sup> O'Brian, Potter & Stafford changed its name to O'Brian, Potter & Company, after Mr. Stafford resigned. (Id., at 14097.)

immediately given a contract by Iroquois Share Corporation to manage that investment company for a period of five years ending on September 15, 1935, at an annual rate of \$25,000 plus an annual bonus of 5% of the investment company's profits.<sup>46</sup> The compensation to Mr. Stafford under the new management contract exceeded the remuneration under the former contract, since the former compensation at the rate of  $\frac{1}{2}$  of 1% of the net worth of the investment company had yielded to O'Brian, Potter & Stafford fees for the year 1929 of only \$12,581, and for 1930, \$7,585, a total of \$20,166 for both years.<sup>47</sup> The annual fee which Mr. Stafford was to receive, without taking into account the possible 5% bonus, was in excess of 1% of the net worth of the investment company in July 1930.<sup>48</sup>

The new management contract between the investment company and Mr. Stafford was never submitted to the stockholders for their approval, although without their knowledge the contract bound the investment company irrevocably for a period of five years to the management of Mr. Stafford, whether successful or not. Any attempt by the stockholders of the investment company to liquidate, to merge with another investment company, or to change the management would require the corporation, and thus indirectly the stockholders, to compensate Mr. Stafford for his contract.

The purchase price paid by Iroquois Share Corporation for the stock of Seventeen Court Street, Inc. constituted approximately 15% of the former's then net assets.<sup>49</sup> In order to pay for the purchase the investment company, which then had no available cash,<sup>50</sup> was required to liquidate readily marketable securities.<sup>51</sup> However, the sale to Iroquois Share Corporation enabled O'Brian, Potter & Stafford to "bail" itself out of an illiquid asset at a time when it needed cash. Mr. Stafford testified to this effect:<sup>52</sup>

Q. I don't think that you have to be squeamish about this, but of course probably every brokerage firm in the country found itself in that position—O'Brian, Potter & Stafford needed cash, isn't that so?

A. That is right.

Q. And it had this 17 Court Street real estate, in which it had [invested] \$313,000?

A. That is right.

Q. And the sale by O'Brian, Potter & Stafford to the investment trust was a means by which, aside from the merits of the sale, a means by which O'Brian, Potter & Stafford could realize that cash quickly, isn't that so?

A. That is quite right.

\* \* \* \* \*

Q. And as part of this transaction, there was an arrangement made whereby O'Brian, Potter & Stafford would cancel their management contract, isn't that so?

A. Yes, sir.

<sup>46</sup> Id., Commission's Exhibit No. 1404.

<sup>47</sup> Id., at 13963.

<sup>48</sup> Id., at 14013. Mr. Stafford testified (ibid.):

Q. In any event, this is a fact——

A. There was a shrinkage, yes.

Q. So that as far as the stockholders were concerned, not only did they buy the property from O'Brian, Potter & Stafford but the [company gave you a] management contract which \* \* \* now had provided for \$25,000 a year, while under the old management contract, with O'Brian, Potter & Stafford, at least at that time, one-half of 1% would not equal \$25,000 a year, isn't that so?

A. It would not.

<sup>49</sup> Id. at 13998 and 14037. As at December 31, 1939, Iroquois Share Corporation had net assets of approximately \$2,100,000. (Id., Commission's Exhibit No. 1422.)

<sup>50</sup> Id., at 13985-6.

<sup>51</sup> Id., at 13989.

<sup>52</sup> Id., at 14006-7.



Q. But they were to keep the option warrants, isn't that so?

A. Oh, yes.

Q. Although the option warrants were given to them as part of the compensation for the management and although they were terminating their relationship as managers, the arrangement was still made to let them keep the option warrants so that if at some future date the corporation was lucky enough to make some money O'Brian, Potter & Stafford could still participate in that profit, isn't that so?

A. That is the way it worked out.

Mr. Stafford testified further:<sup>53</sup>

Q. Now, let us see what the consequence of that deal was, with respect to O'Brian, Potter & Stafford and yourself, and the Iroquois Share Corporation. The Iroquois Share Corporation took you or bailed you out of your commitment in that building, isn't that so?

A. If you want to put it that way.

In response to a further question, the witness said:<sup>54</sup> “\* \* \* ‘Bail’ is a good word.”

Stockholders of Iroquois Share Corporation were first informed of the purchase of all the stock of Seventeen Court Street, Inc. in the investment company's annual report for the year ended December 31, 1930, about six months after the purchase. The fact that the purchase had been made from the firm of O'Brian, Potter & Stafford was not revealed to the stockholders. A letter from Walter F. Stafford, president of Iroquois Share Corporation to the stockholders which accompanied this annual report, stated:<sup>55</sup>

During the year the policy of the management of the Iroquois Share Corporation has been to steer a middle course. Securities have been liquidated, even at a loss, to place the corporation in a strong cash position to take advantage of possible drastic breaks in the market,<sup>56</sup> meanwhile holding a strong list of securities in the event of upturns.

\* \* \* In July 1930, the Corporation acquired the property at 17 Court Street, Buffalo, New York. As of September 15, 1930, Iroquois Share Corporation began to function as a distinct and independent organization, the management contract with O'Brian, Potter, Stafford & Co, then becoming ineffective.

The record affords no indication that the independent directors of Iroquois Share Corporation made any attempt to ascertain the market value of the stock of Seventeen Court Street, Inc., the only asset of which was the equity in the office building then under construction. However, Mr. O'Brian testified that many of these directors were on the appraisal and loan committee of several banks.<sup>57</sup>

The continued decline of business and real estate values made it extremely difficult for Iroquois Share Corporation to rent space in the building. In February 1931, after the completion of the building, O'Brian, Potter & Stafford, Iroquois Share Corporation, and the

<sup>53</sup> Id., at 14016-7.

<sup>54</sup> Id., at 14017.

<sup>55</sup> Id., Commission's Exhibit No. 1403.

<sup>56</sup> The record of the company's activities reveals that actually it stripped itself of cash and became frozen through purchase within a period of several months of Seventeen Court Street, Inc., and the Bank of Williamsville stock.

<sup>57</sup> Op. cit. supra, note 1, at 14096. The first and second mortgages on the building totaled \$827,000. (Id., at 13979.) The Buffalo taxing authorities valued both the land and building owned by Seventeen Court Street, Inc. at \$517,470. (Id., at 13979.) However, this evaluation for taxing purposes is concededly not a conclusive determinant of actual value. The record does not disclose the assessment ratios prevailing in Buffalo at this time.



owner of the cigar stand in the lobby of the building were still the only tenants, six of the seven floors of the building being vacant. Although it was estimated that the expenses of operation of the building would be met only if a minimum of \$2.70 per square foot was secured in rentals,<sup>58</sup> Iroquois Share Corporation was unable to procure tenants by offers to lease at rentals of \$2.25 per square foot and encountered difficulties at \$1.75 per square foot.<sup>59</sup> By April 30, 1931, when Atlas Corporation took over control of Iroquois Share Corporation, the investment company had advanced to Seventeen Court Street, Inc. \$70,055.17<sup>60</sup> which was presumably used to meet the expenses of maintenance of the building. The total investment made by Iroquois Share Corporation in this Seventeen Court Street, Inc. property was \$383,671.49<sup>61</sup> as at April 30, 1931.

Furthermore, in addition to the payment made to the sponsor, additional payments had to be made for uncompleted contracts, as was admitted by Mr. O'Brian.<sup>62</sup>

Q. Now, this has a footnote, "Incompleted building contracts," amounting to [\$118,579.97] and not included in the foregoing balance sheet certified to by Ernst & Ernst, January 12, 1931. Doesn't that mean that in addition to its initial investment of \$313,000 and in addition to assuming any operating deficit which may exist, which in February of 1931 was \$81,000, \* \* \* there were also incompleted building contracts amounting to \$118,579.97?

That represented a very, very substantial commitment by Iroquois Share Corporation, in that real estate venture, did it not, Mr. O'Brien?

A. Well, any building bought in the course of construction, of course, you would obligate yourself to do the same thing, and what proportion that is, I don't know.

Q. And by selling that building to the investment trust, O'Brian, Potter & Stafford was not only relieved of these obligations, that is, the trust took them over with respect to the operating deficit and the incomplete contracts, but O'Brian, Potter & Stafford got every dollar of its money back that it put in, isn't that so?

A. Yes.

Atlas Corporation, in determining the net worth of Iroquois Share Corporation in March of 1931 for the purpose of calculating a ratio of exchange of Atlas Corporation securities for Iroquois Share Corporation stock, tentatively evaluated the stock of Seventeen Court Street, Inc. at \$200,000,<sup>63</sup> but the exchange offer actually made by Atlas Corporation in April of 1931 was based on a calculation of a "realization value" for this stock of only \$45,000.<sup>64</sup>

In 1932, Atlas Corporation surrendered a deed to the property held by Seventeen Court Street, Inc. to the second mortgagee.<sup>65</sup> As a result, the investment in this building was ultimately entirely lost.

Under questioning by counsel for O'Brian, Potter & Stafford, Mr. Stafford justified the purchase of 17 Court Street by the investment company on the ground that "I thought it was an excellent transaction and being a large shareholder of Iroquois I was delighted to

<sup>58</sup> Id., Commission's Exhibit No. 1401.

<sup>59</sup> Id., at 13996.

<sup>60</sup> Id., Commission's Exhibit No. 1422.

<sup>61</sup> Ibid.

<sup>62</sup> Id., at 14000.

<sup>63</sup> Id., at 14004.

<sup>64</sup> Public Examination, Atlas Corporation, Commission's Exhibit No. 2043.

<sup>65</sup> Derived from supplementary information supplied the Commission for Iroquois Share Corporation.

still have an interest in that property and I still think it was a good transaction. It is one of the best business corners in the city of Buffalo.”<sup>65a</sup>

#### 4. INVESTMENTS IN BANK OF JAMESTOWN AND BANK OF WILLIAMSVILLE

Early in 1929 the firm of O'Brian, Potter & Stafford set out to acquire control or obtain a substantial stock ownership in commercial banks. By December of 1929 Iroquois Share Corporation had acquired 1,509 shares out of the 10,000 shares outstanding of the Bank of Jamestown or 15% thereof at a cost of \$129,800. Brewer D. Phillips, a director of this bank, was a director of the investment company. During 1930 and 1931 stock of the Bank of Jamestown was disposed of by the investment company at a loss of \$21,506.74.<sup>66</sup>

The largest single bank investment of Iroquois Share Corporation, however, was in the stock of the Bank of Williamsville. In the minutes of the meeting of the board of directors of the investment company held on May 9, 1929, it was resolved to “purchase up to 300 shares of the stock of the Bank of Williamsville at \$700 a share with the understanding that O'Brian, Potter & Stafford purchase an amount of stock which, with the additional stock held, would establish working control of the Bank.”<sup>67</sup>

During May of 1929 the investment company purchased 300 shares of the stock of the Bank of Williamsville, or 15% of the 2,000 shares of the bank's stock then outstanding, at \$700 per share from various holders for an aggregate cost of \$210,000. On the basis of \$700 per share, the return on the investment did not exceed 2% annually.<sup>68</sup> Prior to the time the investment was made Howard C. Britting was president of the Bank of Williamsville and a director of the investment company.<sup>69</sup> James Chalmers, Jr. was vice president of the bank and later became a member of the board of directors of Iroquois Share Corporation.<sup>70</sup> After the investment had been made, Walter F. Stafford, president of the investment company, and Frederick C. Stevens, a partner of O'Brian, Potter & Stafford and a director of the investment company, became members of the board of directors of the bank.<sup>71</sup> This percentage of bank stock held by the investment company, Mr. Stafford conceded, represented working control of the bank.<sup>72</sup> Mr. Stafford testified:<sup>73</sup>

Q. \* \* \* So that from the very inception it was contemplated that the Iroquois Share Corporation would be in a group which had working control and ultimately with your subsequent acquisitions Iroquois Share Corporation would have working control?

A. Yes, sir.

<sup>65a</sup> Op. cit. supra, note 1, at 14095.

<sup>66</sup> Id., Commission's Exhibit No. 1415.

<sup>67</sup> Id., at 14035-6 and derived from supplementary information supplied the Commission for Iroquois Share Corporation.

<sup>68</sup> Op. cit. supra, note 1, at 14032. In 1928 the Bank of Williamsville paid a dividend of \$16 per share (the par value being \$100) and in 1929, \$12 per share. (Id. at 14032-3 and *Moody's Manual of Investments, Banks, etc.* 1933, p. 489.)

<sup>69</sup> Op. cit. supra, note 1. Commission's Exhibit No. 1390.

<sup>70</sup> Id., at 14031.

<sup>71</sup> Id., at 14035.

<sup>72</sup> Id., at 14035.

<sup>73</sup> Id., at 14036.

In February of 1930 the Bank of Williamsville increased its capital stock from 2,000 shares to 10,000 shares, issuing five new shares for each old share.<sup>74</sup> The 300 shares of the bank stock held by the investment company were, therefore, upon the recapitalization converted into 1,500 shares. In June of 1930 the bank also offered to its stockholders 5,000 additional shares of its stock at \$70 a share. This offering to the bank's stockholders was underwritten by the investment company,<sup>75</sup> which, despite the unfavorable market condition, agreed to take at the offering price all or any part of the 5,000 shares which were not taken by the stockholders. In fact, none of the stockholders agreed to purchase any of the new stock, and the investment company was required to take up the entire 5,000 shares of stock at a cost of \$350,000. Thus the position of the investment company in the stock of the Bank of Williamsville was increased to 6,500 shares at a total cost of \$560,000, or approximately \$86 per share. The 6,500 shares represented in excess of one-third of the outstanding stock of the bank, and this investment by Iroquois Share Corporation in the bank stock constituted approximately 16 $\frac{2}{3}$ % of the net contributed capital of the investment company.<sup>76</sup>

Bearing on this commitment of the investment company to underwrite the 5,000 additional shares of the bank stock is a letter sent by Frederick C. Stevens, a partner in the firm of O'Brian, Potter & Stafford, to the president of Iroquois Share Corporation in which he stated:<sup>77</sup>

I wanted particularly to straighten out the situation in regard to the subscription for the new stock [Bank of Williamsville]. As you know, Iroquois is committed to underwrite the entire amount. The amount that stockholders will take, of course, is problematical, and will remain undecided until the rights expire on June 30th.

I was anxious to get all the directors to sign up to take their full allotment of stock, but Al [<sup>78</sup>] tells me that it is financially impossible for many of them to do it. His suggestion is that since Iroquois is committed to underwrite the unsold balance, that Iroquois loan the different directors sufficient money at 6% to pay for their new stock and to take back their individual notes, give them whatever dividends are paid on the stock, and Iroquois receive 6% for its loan. Personally I would favor such an arrangement because it would mean that ultimately the stock would be placed in good hands and for at least twelve months or so Iroquois would be getting 6% on its money instead of possibly about 3%.

\* \* \* \* \*

<sup>74</sup> *Moody's Manual of Investments, Banks, etc.*, 1933, p. 489.

<sup>75</sup> *Op. cit. supra*, note 1, at 14036-7.

<sup>76</sup> This transaction, it may be noted, followed the investment company's purchase of Seventeen Court Street, Inc., for \$313,616, which the investment company had been able to raise only by selling part of its marketable portfolio.

<sup>77</sup> *Op. cit. supra*, note 1, at 14044-5 and Commission's Exhibit No. 1409. Individuals who were officers and directors of Iroquois Share Corporation and the bank, and also connected with O'Brian, Potter & Stafford, had obligated themselves for the purchase of part of this stock from Iroquois Share Corporation. Loans were made upon the collateral of the Bank of Williamsville stock itself to the following individuals (*id.*, at 14046-7):

J. Arnold Allen-----	\$700. 00
Alfred B. Beiter-----	1, 650. 00
Howard G. Britting-----	7, 000. 00
George L. Hellings-----	5, 950. 00
Howard B. Moore-----	3, 500. 00
Louis P. Schneider-----	2, 800. 00

<sup>78</sup> Albert H. Meyer, a vice president of the Bank of Williamsville, was the one who ultimately purchased the working control of the bank from the investment company when, as a condition of the exchange offer which was made, Atlas Corporation insisted upon the elimination of the bank stock from the portfolio. (*Id.*, at 14047-9 and Commission's Exhibits Nos. 1411 and 1412.)

We are going to do everything we can from the Bank's standpoint to encourage taking up the stock, but if people haven't got the money and can't borrow it, it is going to throw a large total onto Iroquois.

Having acquired the working control of the bank, the investment company was obliged not only to concern itself with the interest of its own stockholders but also to give consideration to the affairs of the bank in which it owned so substantial an interest. Walter F. Stafford testified:<sup>79</sup>

Q. And isn't that, based on your experience, the truth in every case where an investment trust becomes substantially a holding company, where it has not only the investment problem as an investment trust but has the management problem as a holding company? Isn't that so?

A. It is apt to develop that way in times of depression or bad management, or whatever you want to consider it.

On April 3, 1931, when the investment company was desirous of selling its Bank of Williamsville stock in order to complete the exchange deal with Atlas Corporation, Albert H. Meyer, a director of Iroquois Share Corporation and vice president of the Bank of Williamsville, made an offer for the stock at \$25 a share.<sup>80</sup> However, he was permitted to withdraw this offer and he later purchased the stock from Iroquois Share Corporation at \$20 per share. Thus, Iroquois Share Corporation on its investment of \$568,580 in the Bank of Williamsville suffered a loss of \$405,110 or in excess of 70% of the purchase price,<sup>81</sup> the largest single loss suffered by the investment company.

When questioned concerning this transaction by counsel for O'Brian, Potter & Stafford, Mr. Stafford testified as follows:<sup>81a</sup>

Q. \* \* \* The Williamsville Bank stock turned out to be a bad investment in the end?

A. Well, we were forced into making it a bad investment. I don't think it would have been if the Iroquois had continued in existence and held that stock. I think it would have been perfectly all right.

Unfortunate as this venture was for Iroquois Share Corporation, the investment by the company in the Bank of Williamsville was not without its advantages to O'Brian, Potter & Stafford, which, as an investment banking firm, was interested in banks as potential purchasers of securities underwritten by the firm. Control of a bank by an investment company managed by O'Brian, Potter & Stafford tended to insure to this firm the security business of the bank as well as its brokerage business. Thus Walter F. Stafford, a partner of the firm and the president of the investment company, testified:<sup>82</sup>

Q. I say, if the Iroquois Share Corporation had working control of the bank, it might be a source of business to O'Brian, Potter & Stafford?

A. It could be.

Q. Yes; the fact of the matter is——

A. The fact of the matter is that it was a source of business to us before we went into it. We were deriving business from that bank.

Q. You were deriving business from the bank?

A. Oh, yes.

Q. But that source of business could not be [derived] if the management decided not to give you that business. \* \* \* Isn't that so?

A. It would mean a quarrel perhaps.

<sup>79</sup> Id., at 14046.

<sup>80</sup> Id., at 14049.

<sup>81</sup> Id., Commission's Exhibit No. 1415.

<sup>81a</sup> Id., at 14099.

<sup>82</sup> Id., at 14038-9.

The contact with the Bank of Williamsville was almost immediately profitable to O'Brian, Potter & Stafford.<sup>83</sup> In August of 1929 O'Brian, Potter & Stafford, the Bank of Williamsville, and the Bank of Clarence organized the Williamsville Share Corporation as an investment company affiliate of the Bank of Williamsville. O'Brian, Potter & Stafford received underwriting commissions for issuing to the public the stock of the new corporation; became the manager of the new corporation at quarterly fee of  $\frac{1}{8}$  of 1% of the liquidating value; received option warrants as additional management compensation; and also obtained all its brokerage business.

In April of 1930 the assets of Williamsville Share Corporation, as previously stated, were acquired by Iroquois Share Corporation in consideration of the issuance of 29,418 shares of Iroquois Share Corporation stock to the stockholders of Williamsville Share Corporation. In exchange for the warrants of Williamsville Share Corporation held by the Bank of Williamsville, the Bank of Clarence, and by O'Brian, Potter & Stafford, the investment company, Iroquois Share Corporation issued its own warrants evidencing the right to subscribe for 21,500 shares of its own stock before April 1, 1935, at a price of \$20.50 per share. By this exchange of warrants O'Brian, Potter & Stafford received 16,950 additional Iroquois Share Corporation warrants, the Bank of Williamsville 4,050 warrants, and the Bank of Clarence 500 warrants.<sup>84</sup> In order to make all of the warrants issued by Iroquois Share Corporation uniform in price and duration, the period during which the original 50,000 warrants acquired by O'Brian, Potter & Stafford as management compensation could be exercised was extended from December 31, 1932 to April 1, 1935, and their exercise price was raised to \$20.50 per share from \$20 per share.

By April of 1930, therefore, O'Brian, Potter & Stafford had acquired a total of 66,950 warrants of Iroquois Share Corporation—50,000 as management compensation from the investment company under the terms of the management contract of January 23, 1929, and 16,950 as the result of the absorption of Williamsville Share Corporation by the investment company.<sup>85</sup>

Mr. Stafford acknowledged that when an investment banker managed an investment company conflicts might exist between the interest of the investment banker and the investment company with respect to particular investments. He testified:<sup>86</sup>

Q. And the fact is that O'Brian, Potter & Stafford got the underwriting of the securities of the Williamsville Share Corporation, isn't that so?

A. That is correct.

<sup>83</sup> Id., at 14039 et seq.

<sup>84</sup> Public Examination, Atlas Corporation, Commission's Exhibit No. 2001 (p. 91).

<sup>85</sup> Iroquois Share Corporation made another investment in securities which were underwritten by the sponsor. This investment was in Stout D. & C. Air Lines, Inc. Iroquois Share Corporation held 4,200 shares of common stock of this company at an original cost of \$16,960, the market value of which was \$2,100 on April 30, 1931 (Op. cit. supra, note 1, Commission's Exhibit No. 1423.) O'Brian, Potter & Stafford secured a loan of \$400,000 in August 1929 from Stout D. & C. Air Lines, Inc. (id., at 14104), a company which, though supplied with a large capital by the investing public, never functioned beyond purchasing two giant flying boats which could not fly, and finally had to be sold for scrap. Stout D. & C. Air Lines, Inc., was dissolved at a substantial loss to the investing public.

<sup>86</sup> Id., at 14040-1.

Q. And that was subsequent to the time that the investment trust [Iroquois Share Corporation] purchased its initial block of stock in the Williamsville Bank, isn't that so?

A. Yes.

Q. Now in your experience \* \* \* isn't that one of the problems that arises by virtue of the association of investment bankers with investment trusts—that through their affiliation and through the investments of the investment trusts in certain situations, the investment bankers are in a position to get underwriting business, management contracts and so forth?

A. It is all involved, Mr. Schenker, yes; all those features are involved.

Q. And you can visualize the situation, can you not, Mr. Stafford, wherein the Board of Directors or the managers in making an investment judgment for the investment trust, might be put in the position where there is a conflict of interest, in this respect, that although investment A may be a little better for the investment trust, an investment in corporation B might mean a little banking business for the sponsors, there might be some, shall we say, unconscious tendency to favor investment B?

A. I think it is possible.

Q. It isn't unheard of, is it?

A. I don't believe it is unheard of.<sup>87</sup>

## 5. SHORT-SELLING OF THE INVESTMENT COMPANY'S SHARES BY SPONSOR

Following the collapse in security prices in October of 1929, Iroquois Share Corporation began to repurchase its own outstanding shares in the market at prices below their liquidating value. From 1930 to August of 1931 when the investment company was dissolved, it had repurchased 11,182 shares of its own stock at a total cost of \$203,791. At the time Atlas Corporation acquired control of Iroquois Share Corporation 158,920 shares of that investment company were outstanding.<sup>88</sup>

Iroquois Share Corporation's activities in its own stock were apparently utilized by O'Brian, Potter & Stafford in connection with the firm's own market operations in the investment company stock. In February of 1930 O'Brian, Potter & Stafford, as part of its market maintenance activities,<sup>89</sup> sold short 4,900 shares of the stock of Iroquois Share Corporation at an average price of \$15.73 a share.<sup>90</sup> The

<sup>87</sup> As at June 30, 1929, the investment company had acquired by direct purchase from O'Brian, Potter & Stafford 1,500 shares of the stock of Union Natural Gas Company of Canada at a cost of \$60,750. (Id., at 14054.) Both Roland Lord O'Brian and Walter F. Stafford, partners of O'Brian, Potter & Stafford, were directors of this company. In addition, the firm of O'Brian, Potter & Stafford was the banker for the company and had a substantial stock interest in Volcanic Oil & Gas Company, a corporation controlling a majority of the stock of Union Natural Gas Company of Canada.

In November of 1929 O'Brian, Potter & Stafford offered additional stock of Union Natural Gas Company of Canada for sale to the public. (Id., Commission's Exhibit No. 1413.) Following this public offering the holdings of Iroquois Share Corporation in the stock of Union Natural Gas Company of Canada were increased to 2,869 shares at a total cost of \$103,120. (Id., at 14054-5.) Mr. Stafford testified that it was "likely" that Iroquois Share Corporation acquired the additional shares of Union Natural Gas Company of Canada from O'Brian, Potter & Stafford following the public offering of the stock by the firm (Id., at 14056). In addition, Iroquois Share Corporation engaged in a joint account with O'Brian, Potter & Stafford to trade in the stock of Union Natural Gas Company of Canada, presumably to support and maintain the market in the stock. As a result of its purchase of a total of 9,311 shares for \$175,459.13, Iroquois Share Corporation sustained a loss of \$114,817.12. (Id., at 14058.)

<sup>88</sup> Id., Commission's Exhibit No. 1422 (C).

<sup>89</sup> Id., at 14065.

<sup>90</sup> Id., at 14067.

firm covered 4,800 shares of its short position by purchasing from the investment company all its then holdings of its own stock—4,800 shares of treasury stock—at \$15 a share when the market price was \$17 a share.<sup>91</sup> Walter F. Stafford testified:<sup>92</sup>

Q. The fact is that O'Brian, Potter & Stafford were short the stock at \$15.73. By taking the stock down from Iroquois Share Corporation at 15, not only was it taking the stock from Iroquois Share Corporation two points below the market, but was taking it at a price which permitted it to realize a profit of 73¢ a share. Isn't that so?

A. That is correct.

The sale at \$15 per share to O'Brian, Potter & Stafford was made apparently without the knowledge of the board of directors. A letter written by Mr. Stafford, the president of the investment company, in connection with this transaction, stated, in part:<sup>93</sup>

It occurred to me that it might be difficult to explain to the board of directors if anybody saw fit to inquire why he had sold stock at 15 when the market was 17 to ¼.

Except for this difficulty, Mr. Stafford not only did not deem the transaction improper but felt the whole transaction was "in the nature of maintaining the market" and therefore was in the interest of all the stockholders.<sup>94</sup> He testified:<sup>95</sup>

Q. I am talking about the ethics of the thing, and it doesn't matter if it was only five cents involved.

A. Well, it doesn't matter, and I don't see that it was very material.

Q. Just that it gives some indication of the possible consequences that may arise by virtue of the sponsor trying to make a market in the stock, and that might be important for the purposes of our study, by virtue of a close relationship between the investment trust and the sponsoring investment bankers.

A. Now, we disposed of that block of stock at a profit, and it left Iroquois Share Corporation in cash to go ahead and buy additional stock as it came into the market. That was in the interest of all the stockholders.

Q. Mr. Stafford, you are not defending this, are you? When they purchased their own stock, and then sold it to the sponsors to cover a short position?

A. Mr. Schenker, I don't see that that confirms that opinion. The market may have been at 17 when I wrote that letter, and it may have caused me some concern. When the sales were made by O'Brian, Potter & Stafford to its customers, the market was undoubtedly at the price as stated, \$15.73, or whatever it says, and I think they should have been protected on that price.

Since the asset value of the shares was higher than the price to O'Brian, Potter & Stafford, the remaining stockholders of the investment company were deprived of the enhancement in the asset value of their shares which would have accrued had the shares been retired.<sup>96</sup>

## 6. MISREPRESENTATION OF EARNINGS

The shareholders of Iroquois Share Corporation were not only kept in ignorance of the self-dealing power arrogated to the manage-

<sup>91</sup> Id., at 14070.

<sup>92</sup> Ibid.

<sup>93</sup> Id., at 14068; Commission's Exhibit No. 1418.

<sup>94</sup> Id., at 14073.

<sup>95</sup> Id., at 14073-4.

<sup>96</sup> O'Brian, Potter & Stafford realized a profit of approximately \$3,500 instead of sustaining the loss of \$6,100 which the firm would have suffered if it had been compelled to cover its short position in the open market at the time.



ment but evidently were not correctly informed regarding the performance of the company for the first eleven months. A letter by Walter F. Stafford, president of the investment company, to the stockholders under date of January 13, 1930<sup>97</sup> stated that during the eleven months of operation in 1929 "the company showed actual earnings after providing for all expenses, including all expense of organization, of \$371,114 or \$2.78 per share on the 133,334 shares outstanding at the end of the period, although it has enjoyed the use of additional funds realized through the issue of rights for less than one-half of its existence."<sup>98</sup> The actual earnings, however, were \$16,000, not \$371,114.<sup>99</sup> Mr. Stafford testified:<sup>100</sup>

Q. \* \* \* Now the fact is that if you look at the balance sheet, which was certified by Ernst & Ernst, the earnings for the eleven months of the year 1929 did now show actual earnings of \$371,144.44, but showed actual earnings of only \$16,000. Now I will show you how we get that figure.

A. I will concede that figure.

That this financial statement was inadequate was admitted By Mr. Stafford:<sup>101</sup>

Q. Now, another thing that struck me. Mr. Stafford, is that a stockholder would have no way of checking the accuracy of your statement that the earnings were \$371,000 because there is no break-down of the surplus to show how much is capital surplus and how much is earned surplus; isn't that so?

A. That is right.

Mr. Stafford attempted at one point to explain the discrepancy on the ground that a subsequent, though entirely unrelated, paragraph of the same letter indicated that the executive committee had later sold securities for tax loss purposes.<sup>102</sup> However, after further questioning, he testified:<sup>103</sup>

<sup>97</sup> Op. cit. supra, note 1, Commission's Exhibit No. 1421.

<sup>98</sup> Id., at 14084.

<sup>99</sup> Id., at 14084, 14089. The letter stated, "The books of the company have been audited by Messrs. Ernst & Ernst, as of December 31, 1929."

<sup>100</sup> Id., at 14084.

<sup>101</sup> Id., at 14085.

<sup>102</sup> Id., at 14086. The relevant portions of the president's letter are here set forth in order that the merit of Mr. Stafford's contentions may be judged:

During the eleven months of operation in 1929 the company showed actual earnings after providing for all expenses, including all expense of organization, of \$371,114.44, or \$2.78 per share on the 133,334 shares outstanding at the end of the period, although it has enjoyed the use of additional funds realized through the issue of rights for less than one-half of its existence. These earnings consisted principally of interest, dividends, syndicate profits, and profits realized on securities sold.

On October 14, 1929, the board of directors declared a dividend of 5% in stock payable to stockholders as follows:

2% payable January 1st, 1930, to holders of record December 16th, 1929.

1% payable April 1st, 1930, to holders of record March 15th, 1930.

1% payable July 1st, 1930, to holders of record June 15th, 1930.

1% payable October 1st, 1930, to holders of record September 15th, 1930.

The crash in the security market last fall will go down in history as the most rapid and far-reaching collapse of values which this country has ever seen. Your company in common with all others of similar type suffered a very serious shrinkage in the market value of its holdings. It was fortunate, however, in owning its securities outright, and was not compelled to make any sacrifices.

Subsequently it seemed best to your executive committee to sell certain of its securities in order to realize tax losses, and avoid the necessity of paying high federal and state income taxes on the profits that had been previously secured. This policy has further improved the cash position so that as of December 31st, 1929, each share of stock outstanding has behind it cash or its equivalent amounting to \$9.05 per share, while the liquidating value figuring the securities at market was \$19.27 per share.

The last quoted paragraph is the one to which Mr. Stafford alluded as indicating that the earnings were reduced by sales.

<sup>103</sup> Id., at 14089.



Q. Just so we are clear. You don't dispute, whether you put the paragraph underneath or put it two paragraphs away, that [its] actual earnings, after [it took] all the sales for tax purposes and so forth [were] not \$371,000 but [were] \$16,000?

A. I concede that.<sup>103a</sup>

### E. Emoluments to the Sponsor

In addition to approximately \$340,000 received by the sponsor through its connection with the investment company and in addition to the benefit accruing to the sponsor from selling the office building to the investment company.<sup>104</sup> Mr. Stafford testified there were other intangible benefits accruing to the sponsor from its relationship to the investment company:<sup>105</sup>

Q. Now this [\$340,000] which the sponsors received by virtue of their connection, of course, did not include any other \* \* \* business that O'Brian, Potter & Stafford may have received by virtue of their association with the trust, isn't that so?

A. That is right.

Q. When an investment banking firm controls an investment trust, immediately, by virtue of that control of that wealth, it puts itself in a position where it can get banking business, and brokerage business, and the other emoluments that flow from that, isn't that so?

A. What do you mean by "banking business"?

Q. Well, you may have a situation where the investment trust has a substantial block of stock of a corporation and the corporation is seeking to float a new issue of securities, and the probability—

A. You mean investment banking business?

Q. Yes.

A. That is right, that is correct.

Q. And the fact is that that is one of the—shall we say—lucrative sources of income of investment bankers who are associated with investment trusts, isn't that so?

A. It is quite possible.

These emoluments and benefits were obtained by the sponsor during its period of management although during the same period the net contributed capital of \$3,500,014 had shrunk to \$1,454,896. After allowing for payments to stockholders through the repurchases of its outstanding securities by the company and the distribution of dividends,<sup>106</sup> the shrinkage in assets of the investment company during the period of management of O'Brian, Potter & Stafford and Walter F. Stafford, a period of 27 months, was in excess of 50% of its original net capital.

<sup>103a</sup> Subsequently, under interrogation by counsel for O'Brian, Potter & Stafford, Mr. Stafford testified as follows (id., at 14102):

Q. Until counsel [for the Commission] asked you about it, had anybody ever suggested to you or questioned you on the line of there being anything ambiguous, any ambiguity in that letter?

A. No.

Q. Had any stockholder, or any other person, ever spoken to you on the subject of that letter and asked an explanation of it?

A. No.

<sup>104</sup> These benefits were derived as follows: Underwriting fees, \$150,000; brokerage fees, \$29,000; management fees, \$20,166; profits from short selling, \$3,500; minimum cash value of warrants, \$50,212 (see *infra*, p. 74); management fee to Walter F. Stafford, \$11,458 (see *infra*, p. 74); compromise payment to Walter F. Stafford, \$75,000 (see *infra*, p. 73), making a total of \$339,336. In addition the proceeds from Seventeen Court Street, Inc., were \$313,616, increasing the total of these benefits to \$652,952.

<sup>105</sup> *Op. cit. supra*, note 1, at 13966-7.

<sup>106</sup> Public Examination, Atlas Corporation, Commission's Exhibit No. 2003.

## F. Exchange of Shares of Iroquois Share Corporation for Shares of Atlas Corporation

In February 1931 Atlas Corporation learned that the directors of Iroquois Share Corporation desired to free themselves from further responsibility for the investment company. Mr. Stafford stated that everything was "going sour" and many of the directors were getting "cold feet" and were "just sick of it."<sup>107</sup> At that time Atlas Corporation in the negotiations insisted as conditions precedent to any offer exchange of Atlas Corporation stock for Iroquois Share Corporation stock that the Bank of Williamsville stock in the portfolio of the investment company be disposed of at \$40 per share, and that the Iroquois Share Corporation effect a settlement with Walter F. Stafford with respect to the management contract, which, without provision for cancelation on any grounds, was to terminate on September 15, 1935, approximately four years later.<sup>108</sup>

A special committee of four directors of Iroquois Share Corporation was appointed to negotiate the terms of the exchange with Atlas Corporation. On April 3, 1931, the special committee reported that the only offer it had been able to obtain for the Bank of Williamsville stock was \$25 per share from Albert Meyer, one of the directors of the Iroquois Share Corporation and vice president of the Bank of Williamsville. This offer the special committee advised should be accepted.<sup>109</sup> The special committee, in its report, significantly added:<sup>110</sup>

This committee further feels that, due to the type of this particular investment, the Iroquois Corporation should make this sale, even aside from any consideration of the exchange of shares with the Atlas Corporation.

Subsequently, Albert Meyer withdrew his offer of \$25 per share and made a new offer of only \$20 per share which was accepted. Atlas Corporation in computing the terms of its offer of exchange allowed only \$20 per share for the Bank of Williamsville stock,<sup>111</sup> which had cost Iroquois Share an average price of \$86 per share.

The special committee also reported that it had proposed that Iroquois Share Corporation pay \$50,000 for the cancelation of Mr. Stafford's management contract and that in its opinion this represented a very reasonable settlement. However, Mr. Stafford refused the offer. The special committee recommended that Mr. Stafford's terms be met, even though this meant a reduction in the total assets of the investment company and consequently a decrease in the amount of Atlas Corporation securities to be offered for the stock of Iroquois Share Corporation.<sup>112</sup>

Eventually, Iroquois Share Corporation paid \$75,000 to Walter F. Stafford for the cancelation of his management contract. Mr. Staf-

<sup>107</sup> Derived from supplementary information supplied the Commission for Iroquois Share Corporation.

<sup>108</sup> Op. cit. supra, note 1, Commission's Exhibit No. 1404.

<sup>109</sup> Id., Commission's Exhibit No. 1407.

<sup>110</sup> Ibid. At that time under the laws of New York, stockholders of a bank were liable to assessment of 100% of the par value of stock held by them, in order to meet the bank's liabilities. (McKinney's Consolidated Laws of New York; Banking Law [Laws of 1914, ch. 369 as amended] Article III, Section 113a.)

<sup>111</sup> Op. cit. supra, note 1, at 14049-51. Commission's Exhibit No. 1411.

<sup>112</sup> Id., Commission's Exhibit No. 1407.

ford had received \$11,458 under his management contract for the period from about July 1930 to April 1931.<sup>113</sup> Thus, the management contract brought to Mr. Stafford a total of \$86,458.

On April 6, 1931 the board of directors of the investment company approved a contemplated offer by Atlas Corporation to exchange for each share of Iroquois Share Corporation either  $1\frac{1}{10}$  shares of Atlas Corporation common stock or, as an alternative, a unit consisting of  $\frac{1}{6}$  of a share of Atlas Corporation preference stock plus  $\frac{4}{10}$  of a share of Atlas Corporation common stock.<sup>114</sup>

Atlas Corporation also agreed to accept Iroquois Share Corporation warrants in exchange for Atlas Corporation warrants at the rate of  $\frac{2}{3}$  of one Atlas Corporation warrant for each Iroquois Share Corporation warrant. The warrants of Iroquois Share Corporation had no market value, whereas Atlas Corporation warrants were actively traded on the New York Curb Exchange and sold during April 1931 between  $\$2\frac{1}{8}$  and  $\$1\frac{3}{8}$ , and in May between  $\$1\frac{1}{2}$  and  $\$1\frac{1}{8}$ .<sup>115</sup> The offer of exchange of warrants was to be binding upon Atlas Corporation only if the holders of at least 51% of outstanding stock of Iroquois Share Corporation accepted the Atlas Corporation offer for such stock.<sup>116</sup>

O'Brian, Potter and Company and Walter F. Stafford owned 66,950 Iroquois Share Corporation warrants which would be exchangeable for 44,633 Atlas Corporation warrants with a market value of \$50,212.50 if the holders of 51% of the stock of Iroquois Share Corporation exchanged their shares for Atlas Corporation shares.<sup>117</sup> It is apparent, therefore, that O'Brian, Potter and Company and Walter F. Stafford had a very material incentive to advise Iroquois Share Corporation stockholders to exchange their stock for Atlas Corporation stock, and they did so advise them. Walter F. Stafford, who, as has been indicated, had a block of Iroquois Share Corporation warrants, addressed a letter jointly with R. S. Persons, as president of the investment company and chairman of the board of directors respectively, to the stockholders of the investment company in which they "strongly urge" the acceptance of one of the alternative exchange offers made by Atlas Corporation.<sup>118</sup> No reference was ever made to the fact that Atlas Corporation was offering to exchange its warrants for Iroquois Share Corporation warrants, or to the fact that such exchange of warrants was conditioned upon the acceptance of the exchange of stock by holders of at least 51% of the stock of the investment company. Nor was a disclosure made of the fact that O'Brian, Potter and Company and Walter F. Stafford owned the bulk of the Iroquois Share Corporation warrants.

The combination of preference and common stock offered by Atlas Corporation had an asset value of \$10.37 per unit as compared with an asset value of \$9.07 per share of Iroquois Share Corporation

<sup>113</sup> Id., at 13963.

<sup>114</sup> Originally Atlas Corporation had offered  $1\frac{1}{2}$  shares of common, but this had been reduced to  $1\frac{1}{6}$  share, presumably because of the lower Iroquois Share Corporation asset value resulting from the increased payment to Mr. Stafford and the lower price received from the Bank of Williamsville stock. (Id., Commission's Exhibit No. 1407.)

<sup>115</sup> Id., at 13964-5.

<sup>116</sup> Id., Commission's Exhibit No. 1412.

<sup>117</sup> Public Examination, Atlas Corporation, Commission's Exhibit No. 2001.

<sup>118</sup> Id., Commission's Exhibit No. 1970.

stock.<sup>119</sup> Actually, therefore, acceptance of this offer benefited Iroquois Share Corporation stockholders assetwise, to the extent of \$1.30 per share of their stock. Marketwise, this offer was also advantageous to Iroquois Share Corporation stockholders because the Atlas Corporation unit of securities had a market value of \$9.30 as compared with the market value of \$7.75 per share of Iroquois Share Corporation stock.<sup>120</sup>

The acceptance of the alternative exchange offer of only Atlas Corporation common stock involved a gross loss in assets to each Iroquois Share Corporation stockholder of \$1.90 on each share held because the Atlas Corporation stock offered had an asset value of \$7.17 as compared with an asset value of \$9.07 for each share of Iroquois stock. Marketwise, however, the Atlas Corporation stock offered was worth \$1.35 more than Iroquois Share Corporation stock.<sup>121</sup>

No attempt was made by the management or the sponsor of Iroquois Share Corporation to point out to the stockholders the advantage of accepting the unit of preferred and common instead of the common alone. In fact, the letter of Iroquois Share Corporation stressed the fact that the Atlas Corporation offer of common stock was "attractive to those who are interested in the possibility of enhancement in market value."

The great majority of the Iroquois Share Corporation stockholders accepted the second alternative, the offer of Atlas Corporation common stock. The offer resulted in Atlas Corporation acquiring 140,302 shares of Iroquois Share Corporation stock out of the 158,279 shares outstanding. In the exchange, Atlas Corporation issued 6,849 shares of its preference stock and 155,322 shares of its common stock.<sup>122</sup>

As a result of the exchange, Iroquois Share Corporation stockholders sustained a gross loss in asset values of \$134,845.<sup>123</sup> At the same time, the market value of the Atlas Corporation options received by O'Brian, Potter and Company and Walter F. Stafford was, at a minimum, \$50,212.50. In addition Mr. Stafford, as stated above, received \$75,000 for termination of his management contract.

<sup>119</sup> The stockholders of Iroquois Share Corporation had originally subscribed for 100,000 shares in January of 1929 at \$20 per share, for 33,334 shares in July of 1929 at \$32.50 per share and for 29,418 shares in April of 1930 at approximately \$21 per share. No cash dividends had ever been paid on these shares but a stock dividend totaling 7,350 shares, which was charged against an unearned capital "surplus" created out of the original funds contributed by the stockholders to the company, had been paid in 1930. (Op. cit. supra, note 1, Commission's Exhibit No. 1422.)

<sup>120</sup> Id., Commission's Exhibit No. 2001.

<sup>121</sup> Id., Commission's Exhibit No. 2001, p. 93.

<sup>122</sup> Mr. Stafford testified that at the date of the hearing, March 30, 1937, a stockholder of Iroquois Share Corporation who had purchased his shares at the original offering price of \$21.50 per share and had exchanged his shares for Atlas Corporation common stock, held Atlas Corporation stock with a then market value of \$25.50. (Id., at 14093.) However, as at February 28, 1939, the market value of the  $1\frac{1}{4}$  shares of Atlas Corporation common stock which had been exchanged for each share of Iroquois Share Corporation stock had declined to \$10.75 a share, so that over the period 1929-1939 the stockholder of Iroquois Share Corporation who had exchanged his shares for Atlas Corporation common stock had suffered a net loss marketwise of \$10.75 per share or one-half of the original offering price.

<sup>123</sup> Id., Commission's Exhibit No. 2001, p. 94. However, by becoming stockholders of Atlas Corporation as a result of this exchange, some part of this loss in asset value was retrieved by the shareholders of Iroquois Share Corporation.

At the conclusion of the public examination before the Commission concerning the affairs of Iroquois Share Corporation, Mr. Stafford, under questioning of counsel for O'Brian, Potter & Stafford asseverated the good faith of himself and his associates. He testified:

Q. And did you ever, yourself, in all your connection with the Iroquois Share Corporation, did you ever yourself consciously attempt to use that corporation or permit its use as a receptacle for undesirable stocks?

A. Certainly not, and from my relations with the other members of the firm it was not so treated by anybody. It was treated with the utmost consideration. Wherever we thought we could make a profit for the corporation it was done. On the face of it—we had all our customers in this corporation as stockholders and we had to do the best we could for it.

## II. SEABOARD UTILITIES SHARES CORPORATION, RAILROAD SHARES CORPORATION, AND UTILITIES HYDRO & RAILS SHARES CORPORATION

### A. Summary

C. D. Parker & Co., Inc., an investment banking firm of Boston, Massachusetts, in 1929 organized Seaboard Utilities Shares Corporation, an investment company; and, after the partial distribution of the securities of that company, sponsored two additional investment companies, Railroad Shares Corporation and Utilities Hydro & Rails Shares Corporation. The three investment companies received a total of approximately \$25,000,000 from the sale of their shares to investors, although this figure is substantially less than the amount paid to the sponsor and dealers by such investors in purchasing these shares.

Cash of the three investment companies, amounting to \$3,304,766.62 by December 21, 1935, was deposited with C. D. Parker & Co., Inc., the sponsor, although the latter was not authorized to act as a bank of deposit at any time. Approximately half of this amount, including \$1,295,000 in certificates of deposit, was transferred to C. D. Parker & Co., Inc., after March 1931, the earliest date at which the insolvency of C. D. Parker & Co., Inc. has been established. In 1934, when the Banking Act of 1933, requiring the divorcement of private banking from investment banking, became operative, the sponsor did not return the funds of the investment companies which were supposed to be on deposit with it. Instead, the sponsor during the period of insolvency changed the entries on the books of account of the investment companies. Accounts which had been previously termed "checking accounts," "certificates of deposit," and "funds reserved for the payment of securities under order" were designated as "funds reserved for the purchase of securities under order." Receivers were appointed for the sponsor in April 1935 and these cash deposits amounting to \$3,304,766.62 probably represented a total loss to the stockholders of the investment companies.

In the latter part of 1929, Seaboard Utilities Shares Corporation, having invested all its funds in securities, borrowed funds from banks for the purpose of purchasing additional securities, pledging portfolio securities as collateral. These loans amounted to \$1,285,000 in April 1932. During the declining market from 1929 to 1932, the investment company delivered portfolio securities to supply additional collateral for these loans until over two-thirds of the market value of the entire portfolio of the investment company was in the hands of the banks. Portfolio securities valued at \$2,000,000 as at December 31, 1931 were pledged to secure the loans. In April 1932, the banks called the loans and sold this collateral. When the loans were called the investment company had over \$1,270,000 on deposit with C. D. Parker & Co., Inc. the sponsor, which failed to make this amount available to the investment company to meet its obligations to the banks and permitted the banks to foreclosure the collateral.

C. D. Parker & Co., Inc. converted approximately \$250,000 of the portfolio securities of the three investment companies by hypothecating them as collateral for its own loans.

The various practices of C. D. Parker & Co., Inc. were not disclosed to the stockholders or to the directors of the investment companies. The public ac-

countants engaged by Bowen Tufts, who actually managed the sponsor and the investment companies, were substantially influenced by the desires of Bowen Tufts in the course of their audits. The financial statements certified by these accountants were misleading and incomplete in material respects. The statements failed to show that practically all the cash funds of the investment companies were in the custody of the sponsor and not on deposit in authorized banks of deposit. The certified statements issued for one investment company failed to mention that over two-thirds of the portfolio securities were pledged for bank loans. The statements of another investment company showed capital stock as issued and paid for when such stock was merely at the perpetual call of the sponsor at \$10 a share. The statement of each company included as an asset, without explanation, an item called "contracts" representing a substantial valuation placed by the directors on a contract to receive management services from C. D. Parker & Co., Inc. without cost. The accountants, without physically examining the securities, accepted letters of confirmation from the sponsor as verification that portfolio securities owned by the investment companies were in the sponsor's custody.

Of the \$25,000,000 actually received by the three investment companies, \$4,000,000 was returned to investors, through repurchases of shares amounting to approximately \$1,700,000 and through dividends amounting to approximately \$2,300,000. Virtually the entire balance of \$21,000,000 has been lost, except for any small amounts, which may possibly be salvaged by the receiver of these three companies.

### B. C. D. Parker & Co., Inc., the Sponsor

C. D. Parker & Co., Inc., an investment banking firm of Boston, Massachusetts,<sup>1</sup> organized three investment companies during the year 1929: Seaboard Utilities Shares Corporation in March; Railroad Shares Corporation in July; and Utilities Hydro & Rails Shares Corporation in November.

C. D. Parker & Co., Inc. had experienced financial difficulties in 1907, 1914, 1921, and 1929. By March 1931 the firm showed a deficit of several hundred thousands of dollars and thereafter its financial stress increased in 1932 and 1933.<sup>2</sup> In 1935, C. D. Parker & Co., Inc. went into receivership.<sup>3</sup>

Immediately prior to the formation of the three investment companies, the principal activity of C. D. Parker & Co., Inc. was the distribution of the securities and management of Massachusetts Utilities Associates, a utility holding company, in which it held an investment position.<sup>4</sup> In the early part of 1929, C. D. Parker & Co., Inc. sold its investment position and turned over the management of the Massachusetts Utilities Associates to the New England Power Association.<sup>5</sup> After this sale, C. D. Parker & Co., Inc. organized the first of three investment companies it sponsored, Seaboard Utilities Shares Corporation, an investment company of the management type, to invest principally in public utility securities.<sup>6</sup>

<sup>1</sup> The officers and principal stockholders of C. D. Parker & Co., Inc. were Chauncey D. Parker, president; Bowen Tufts, vice president and general manager; Merton E. Grush, vice president; Harold B. Lamont, vice president; Charles R. Adams, vice president; and Edward L. Bennett, treasurer. (Public Examination, C. D. Parker & Co., Inc., at 20885-7.)

<sup>2</sup> Public Examination, C. D. Parker & Co., Inc., at 20936-7.

<sup>3</sup> Id., at 21000.

<sup>4</sup> Id., at 20888, 20894-6.

<sup>5</sup> Id., at 20897.

<sup>6</sup> Id., at 21045.

### C. Seaboard Utilities Shares Corporation

Seaboard Utilities Shares Corporation was organized originally in Massachusetts on March 20, 1929, but subsequently was reorganized and incorporated under the laws of Delaware on January 2, 1930.<sup>7</sup>

The charter authorized the issuance of 2,500,000 shares of common stock of no par value.<sup>8</sup> The sponsor, which had the underwriting contract but no firm commitment, formed a syndicate to sell the shares to the public.<sup>9</sup> The net proceeds to the company from the sale of 1,600,000 shares to the public were \$16,525,000.<sup>10</sup>

While the investment company received an average of \$10.32 a share the sponsor distributed the shares to the public at \$11 a share and upwards through dealers, who in the main had day-to-day options. Distribution of the shares was apparently still proceeding in August 1929, when the market price of the shares reached its high of \$18.25 a share.<sup>11</sup> It appears that the excess of the price paid by investors over the price paid to the investment company was divided among dealers and the sponsor, although the extent or division of the distribution profits is not indicated. The sponsor held no investment position in the investment company except insofar as it had an interest in the syndicate which was selling the shares of the company.<sup>12</sup>

As an aid in marketing the shares of the investment company, the security dealers of the syndicate which distributed the shares to the public were elected to the board of directors of the investment company. J. Lewis Henry, a dealer director of the investment companies, testified that the election was "flattery" and gave the dealers "a better standing with their present \* \* \* and prospective clientele in the matter."<sup>13</sup>

The board of directors consisted of 45 members of whom 17 were employees or officers of the sponsor and 28 were dealers and distributors of securities located throughout the country. Approximately this same proportion of employees and officers of the sponsor and the security dealers on the board of directors was maintained from 1929 to 1934.<sup>14</sup> Four of the principal officers and stockholders of the sponsor were principal officers of the investment

<sup>7</sup> The sponsor was advised by counsel that the Massachusetts law did not permit the payment of dividends from income on investments when there was an impairment of capital due to the depreciation of the market value of the portfolio securities. (Id., at 20901.) Harold B. Lamont, vice president and secretary of the sponsor, testified (id., at 20901-2): "It seemed at that time that it was unjust to the shareholders of the corporation if they should be deprived of any dividends that the corporation might earn due to a fluctuation in the value of its securities."

Although the right to pay dividends when there was an impairment of capital due to depreciation of the market value of portfolio securities was the factor which induced the sponsor to reorganize the company in Delaware (id., at 20902), dividends aggregating \$1,504,923.05 were distributed during the first two years of the company's existence from July 1, 1929, to August 1, 1931, but no dividends were paid thereafter. (Id., at 21035, 20905, and Commission's Exhibit No. 3246.)

<sup>8</sup> Op. cit. supra, note 2, at 20907.

<sup>9</sup> Id., at 20908.

<sup>10</sup> Id., Commission's Exhibit No. 3244.

<sup>11</sup> Id., at 21036, 21046-7, 20900. C. D. Parker & Co., Inc. offered 500,000 shares of Seaboard Utilities Shares Corporation at \$11 per share in June 1929. (*Moody's Manual of Investments, Banks, etc.*, 1930, p. 2288.)

<sup>12</sup> Id., at 20910.

<sup>13</sup> Id., at 21048.

<sup>14</sup> Id., Commission's Exhibit No. 3241.



company, namely, Chauncey D. Parker, president; Bowen Tufts, vice president; Merton E. Grush, treasurer; and Edward L. Bennett, secretary.<sup>15</sup>

The control of the sponsor over the activities of the investment company was achieved in large measure by preserving this type of board of directors. At the first meeting in 1929, the board of directors delegated to Bowen Tufts, the executive vice president and director, sole control over the purchase and sale of the securities in the portfolio of the investment company.<sup>16</sup> The domination of C. D. Parker & Co., Inc. was further insured by a management contract with the investment company for a period of 20 years,<sup>17</sup> under which C. D. Parker & Co., Inc. was to receive no management compensation. This contract was set up as an asset on the books of the investment company, in an account merely termed "Contracts" valued at \$166,666.67, while a surplus account designated "Other Surplus" was credited.<sup>18</sup> This "Contract" account was amortized against "Other Surplus" on a 20-year basis. There was no disclosure in the published financial statements that this item was its contract for management by the sponsor, C. D. Parker & Co., Inc. In this respect, A. T. Stanwood, who was not a certified public accountant but did most of the auditing work for the investment company, testified:<sup>19</sup>

Q. Whose idea was it to set up a management contract with Seaboard Utilities Shares? In the amount of \$200,000 [sic. \$166,666.67]?

A. I believe that was a vote of the board of directors, placing a value of \$200,000 [sic. \$166,666.67] on it.

Q. I think you will agree with me that that was a rather ludicrous thing to do, wasn't it?

A. It was an amount of money.

\* \* \* \* \*

Q. As a matter of fact, this management contract was anything but an asset, wasn't it? It proved to be a terrific liability, didn't it?

A. As it turned out.

C. D. Parker & Co., Inc. also acted as depositary of the cash funds of the investment company.<sup>20</sup>

The dealers and distributors on the board of directors of the investment company actually never functioned as directors. Mr. Henry, at that time a member of the firm of Biddle & Henry, distributors of investment securities, of Philadelphia,<sup>21</sup> testified that notices of the board meetings were received by him usually on the day of the meetings or the day before the meetings. He complained to Bowen Tufts concerning the short notices of meetings in a letter, as follows:<sup>22</sup>

<sup>15</sup> Ibid. See note 1, supra.

<sup>16</sup> Id., at 20940-1.

<sup>17</sup> The management contract was not made available to the Commission. It was amortized over a 20-year period and it appears that it was of 20 years' duration. (Id., Commission's Exhibit No. 3240.)

<sup>18</sup> Id., Commission's Exhibit No. 3240.

<sup>19</sup> Id., at 20980-1. Mr. Stanwood was a member of the firm of Chas. E. Stanwood & Sons, Inc., certified public accountants, engaged by Bowen Tufts to audit the books of the investment companies. (Id., at 20974-5, 21041.) Mr. Stanwood had previously been connected with C. D. Parker & Co., Inc. in doing the accounting for Massachusetts Utilities Associates. (Id., at 20904 and see note 4, supra.)

<sup>20</sup> Id., at 20938.

<sup>21</sup> Id., at 21043.

<sup>22</sup> Id., at 21049.



It is very unfortunate such short and unusual notice is given of meetings of these corporations, as it has been my express desire for a long period of time to obtain information pertaining to the status of the companies and I should like for the opportunity to plan to attend the meeting. Could not some arrangements be made to give longer notices?

Harold B. Lamont, one the principal stockholders of the sponsor, and a director of the investment company, testified that during his period of tenure, he objected to the manner in which the portfolio securities were selected and resigned after one year and eight months<sup>23</sup> because the control of the company, including the purchase of portfolio securities, was "all in the hands of one man practically"—Bowen Tufts.<sup>24</sup>

In the latter part of 1929, after the entire contributed capital of the investment company was invested in securities, Seaboard Utilities Shares Corporation borrowed substantial sums from banks to purchase additional securities and collateralized these loans with portfolio securities.<sup>25</sup> As of December 31, 1930 these loans amounted to \$1,750,000 but were reduced to \$1,285,000 by April 1932 when the loans were called.<sup>26</sup> From 1929, the year of the loans, to 1932 the market value of the portfolio steadily declined, and the banks periodically required additional collateral to secure the indebtedness.<sup>27</sup> The banks accepted only the higher priced portfolio securities as collateral, leaving the less desirable securities with the investment company.<sup>28</sup>

The market value of the portfolio of the investment company by December 31, 1931 (including the securities pledged with the banks) had depreciated in value to \$3,112,535.89.<sup>29</sup> The securities held by the banks were valued at market at \$2,180,853.25, representing over two-thirds of the total market value of the portfolio.<sup>30</sup>

The balance sheet of December 31, 1931, purporting to describe the situation, stated in a footnote that of securities owned and purchased at a cost of \$14,276,468.52 "certain of these securities are pledged as collateral on notes payable for purchase of securities." There was no disclosure in the annual reports of the fact that two-thirds of these securities, at market value, were held by the banks as collateral for their loans. Mr. Stanwood, the accountant, admitted that this statement was doubly misleading:<sup>31</sup>

Q. As a matter of fact, through the annual reports they believed that \$14,000,000 at cost of portfolio securities was held by the trust and that cer-

<sup>23</sup> Id., at 20939-41.

<sup>24</sup> Id., at 20940.

<sup>25</sup> Id., at 20948-9, 20977.

<sup>26</sup> Ibid.

<sup>27</sup> Id., at 20950.

<sup>28</sup> Mr. Lamont testified (ibid.):

Q. Of course the banks accepted only the better securities as collateral when the loans were made.

A. There was a rule at that time put into effect by the banks, or the Federal Reserve, or somebody, that whenever a security sold for less than \$10 a share, it became unacceptable as collateral, and it was shifted from the loan to the portfolio and substitutions made from the portfolio of stocks at a higher price than \$10.

Q. Yes, that tended to put the less desirable securities in the portfolio and the best securities in the hands of the bank. As a matter of fact, in order to borrow and keep outstanding the indebtedness in the amount of \$1,285,000, additional collateral from time to time had to be supplied to the bank out of the portfolio?

A. That is right.

<sup>29</sup> Id., at 20952.

<sup>30</sup> Id., Commission's Exhibit No. 3240.

<sup>31</sup> Id., at 20978-9.

tain of these portfolio securities were pledged as collateral not only for loans but also reserved for the purchase of other securities; isn't that so?

A. That is right.

Q. In other words, it was doubly misleading; isn't that so?

A. It seems so from these reports.

Concerning the reason for the failure to show these facts in the financial statements, Mr. Stanwood testified that the footnote to the report originally set forth the amount of the securities pledged, but that he was not permitted to put the amount in the report in its final form:<sup>32</sup>

A. For example, you read a footnote a few minutes ago, "certain of these securities"; I had the amount of those securities in there.

Q. You did have?

A. I was not permitted to put that in.

Q. You were not?

A. No, sir.

Q. Because the amounts would have shown that over 80 percent of the securities of the whole trust was in the bank as collateral for loans?

A. I don't know the percentage, but it was substantial.

In April 1932 the banks called the loans and, upon the failure of the investment company to pay, sold the collateral.<sup>33</sup> During this month when the forced liquidation of the loans occurred, the books of the investment company indicate that losses of over \$600,000,000 on the basis of cost were suffered from the sale of portfolio securities.<sup>34</sup> These losses comprised approximately half of the total of all losses on the sale of securities by the investment company during its existence.<sup>35</sup> At the time when this sale took place, the investment company had on deposit over \$1,270,000 with C. D. Parker & Co., Inc.<sup>36</sup> which had acted as depositary of the cash funds of the investment company shortly after its inception.<sup>37</sup> If this money had been paid to the banks it would have been approximately sufficient to satisfy the investment company's entire indebtedness and thus might have conserved a substantial part of its assets.<sup>38</sup> The sponsor, nevertheless, did not take any action to avert the foreclosure of the collateral.<sup>39</sup>

Mr. Stanwood, the accountant, testified concerning this situation as follows:<sup>40</sup>

Q. How much collateral do you think would have to be on hand to cover \$1,300,000 [loans with] the bank?

A. Probably a couple of millions.

Q. \* \* \* So that you would have at least 80% of the securities of the trust pledged with the bank, isn't that so?

A. Yes.

Q. So that the bank virtually owned the trust for that loan?

A. I should say so.

Q. Yet the stockholders did not know that?

A. That is right.

<sup>32</sup> Id., at 20977-8.

<sup>33</sup> Id., at 20952-3.

<sup>34</sup> Derived from supplementary information supplied the Commission for C. D. Parker & Co., Inc.

<sup>35</sup> Op. cit. supra, note 2, Commission's Exhibit No. 3244.

<sup>36</sup> Id., at 20954-5; and op. cit. supra, note 34.

<sup>37</sup> Op. cit. supra, note 2, at 20938.

<sup>38</sup> Id., at 20952-3.

<sup>39</sup> The record does not disclose the reason for this failure to pay the loan. Probably, the sponsor which was insolvent at the time did not have available funds. (Op. cit. supra, note 2.)

<sup>40</sup> Id., at 20977-8.

Q. Now in addition to that C. D. Parker & Co., Inc. had over \$900,000 [sic, \$1,270,000] in cash on deposit, didn't they?

A. Yes.

Q. Belonging to the trust?

A. I should say around that amount.

Q. And yet not a penny of that cash was used by C. D. Parker & Co., Inc. to pay off the loan to the National Shawmut Bank of Boston and to avoid the calamity of foreclosing on virtually every share in the portfolio of that trust?

A. That is so.

Q. Now, what made that possible? Were the shareholders advised in that situation?

A. Not through any annual report that was published that I know of.

Mr. Henry, one of the dealer-distributor directors, testified that he and the other dealers had no knowledge of the loan and the cash deposits:<sup>41</sup>

Q. At any rate, did you know that after substantially all of the contributed capital was used to purchase securities that were put into the portfolios of these companies, those securities were promptly pledged as collateral for a loan from the bank, the National Shawmut Bank of Boston, and the cash so obtained was used to purchase more securities?

A. On that point my understanding was, going back to the formation of the company and the distributing days, it would be absolutely contrary to the policy of the company to make any loans. I have no recollection of learning that a loan had been made for probably three years afterwards, in 1932.

Q. Well, the fact is they had borrowed from the National Shawmut Bank of Boston by April of 1931——

A. April 1931?

Q. Yes.

A. Gee, that's funny.

Q. They had borrowed \$1,200,000-odd dollars—against which they had pledged over two-thirds of the whole portfolio of the trust as security. You did not know that?

A. I never knew that at all.

Q. And on top of that the bank foreclosed on the collateral and sold them out in order to pay off that indebtedness at a time when C. D. Parker & Company held over \$900,000 [sic, \$1,270,000] in cash belonging to the trust. You did not know that?

A. In my opinion no dealer or stockholder was ever so advised. I never learned that. I never knew it until today.

Not only did the sponsor retain the investment company's cash at so critical a time, but subsequent to April 1932, when the bank loan was called, it even increased the amount of cash funds that it presumably held on deposit for Seaboard Utilities Shares Corporation. This procedure was also followed by the sponsor in dealing with the other two investment companies, Railroad Shares Corporation and Utilities Hydro & Rails Shares Corporation.

In securing control of the funds of the investment companies, three distinct accounts were kept with the sponsor, C. D. Parker & Co., Inc. ostensibly for three separate purposes: a checking account,<sup>42</sup> an account for the purchase and payment of securities under order,<sup>43</sup> and an account under which the sponsor issued certificates of deposit.<sup>44</sup> Although these three accounts bore different titles on the books of the companies all three forms, according to Mr. Stanwood, represented the "same thing."<sup>45</sup>

<sup>41</sup> Id., at 21053-4.

<sup>42</sup> Id., at 21016.

<sup>43</sup> Id., at 21017.

<sup>44</sup> Ibid.

<sup>45</sup> Ibid.

Despite the fact that the assets of the three investment companies were constantly depreciating in value, the balances of the checking accounts tended to increase throughout their existence, as did, in fact, all the funds on deposit with the sponsor.<sup>46</sup>

The manner in which the sponsor secured the funds of the investment companies as depository is indicated in the following testimony of Mr. Stanwood:<sup>47</sup>

Q. To recapitulate the procedure adopted by C. D. Parker & Company in, shall we say, capturing the funds of these trusts, it was in three separate forms. The first form was by way of checking accounts which were opened, is that right?

A. Right.

Q. And then you had the special forms which were special funds deposited to pay for securities under order.

A. Right.

Q. And then you had the third form which was the certificates of deposit which were issued by the sponsor to the trust, is that right?

A. All meaning the same thing; that is different titles.

Q. But they were carried as separate accounts. On the books of the trust you had these three separate accounts from the inception.

A. That is right.

\* \* \* \* \*

Q. These special funds that were deposited to pay for the securities under order, those funds were augmented by the retention of the proceeds received by the sponsor on the sales of securities, weren't they?

A. Right.

Q. So that it swelled in amount as it went on.

A. Right.

Q. Which was rather unusual for an account which was supposed to be used to purchase securities under order.

A. That is correct.

Q. You would normally find an account in which funds were deposited for such purpose, gradually being eaten up through the purchase of securities.

A. That would be the tendency with the account.

Q. But instead in C. D. Parker & Company this fund kept swelling all the time, isn't that so?

A. That is right.

Q. And with respect to the checking accounts that were opened with the sponsor, those were increased as of year ends right regularly on through the period of operation of these trusts.

A. The tendency was to increase.

This increase was substantial even after March 1931, the earliest date at which the insolvency of C. D. Parker & Co., Inc. has been established. A total of \$1,798,210.38 was transferred by the three companies to C. D. Parker & Co., Inc. after December 31, 1930, which amount includes \$1,295,000 in certificates of deposit purchased by the three investment companies in December 1931.<sup>48</sup>

Although the investment companies were entitled to interest on the certificates of deposit as it accrued, the interest was not actually paid but was added to an accrued interest account.<sup>49</sup> The financial statements issued to the public listed the "certificates of deposit" among the assets but it was not disclosed that these certificates of deposit were issued by the sponsor of the three investment companies, C. D. Parker & Co., Inc. and not by a bank.<sup>50</sup>

<sup>46</sup> Id., at 21018.

<sup>47</sup> Id., at 21016-8.

<sup>48</sup> Id., Commission's Exhibit No. 3235; and op. cit. supra, note 34.

<sup>49</sup> Ibid.

<sup>50</sup> Op. cit. supra, note 2, at 20967-9.

Mr. Henry, a director of the investment companies, testified that he was completely misled by the financial statements issued by the investment companies: <sup>51</sup>

Q. You found an abbreviated statement or balance sheet giving you some resultant figures and a break down?

A. Yes.

Q. Three certificates of deposit were listed on that statement. You never knew whether the certificates of deposit were issued by the National Shawmut Bank of Boston or by whom it was issued?

A. That is correct.

Q. You thought that \* \* \* some bank authorized by the banking laws did issue these certificates of deposit?

A. It is my exact recollection that all fiduciary activities were segregated—securities and cash—entirely apart from C. D. Parker & Company and that was always my impression until today. I never knew otherwise.

Q. You never knew that C. D. Parker was acting as depository for this cash?

A. No, never—until about a week or two ago.

Q. And certainly [had not issued] certificates of deposit?

A. No, sir.

By June 16, 1934, Seaboard Utilities Shares Corporation had deposited with C. D. Parker & Co., Inc., \$1,957,417.61, consisting of cash deposits in a checking account aggregating \$622,491.64; certificates of deposit issued by the sponsor, including accrued interest amounting to \$888,335.42; and funds reserved for the payment of securities under order, amounting to \$446,590.55.<sup>52</sup> As will later be shown in more detail, the other two investment companies by that time had likewise deposited with C. D. Parker & Co., Inc. an aggregate amount of approximately \$1,182,191.17, of which \$478,700.18 comprised cash deposits in checking accounts and certificates of deposit, including interest.

Thus, when the Banking Act of 1933, compelling the divorcement of private and commercial banking from investment banking, went into effect on June 17, 1934,<sup>53</sup> the three investment companies had \$3,139,608.78 with their sponsor, of which \$1,989,527.24 was in cash deposits in checking accounts and certificates of deposit.<sup>54</sup> Since C. D. Parker & Co., Inc. was engaged in the investment banking business, it was required to return to the investment companies the \$1,989,527.24 on deposit with itself. However, at this time the sponsor was insolvent and these cash deposits were not turned over to the investment companies. Instead, the sponsor changed the designation of all deposit accounts, then aggregating \$3,139,608.78, describing them as "Funds reserved for the purchase and sale of portfolio securities under order" and as "Funds reserved for the purchase and sale of treasury shares under order."<sup>55</sup>

Mr. Stanwood, describing the conception of the plan to redesignate the cash deposits as a securities account, testified: <sup>56</sup>

Q. Well, whose idea was it to create this super-special fund into which all the cash on deposit with C. D. Parker & Company was to be given the appearance of a brokerage account?

A. Those were the two funds, one to purchase treasury shares, and the other portfolio shares?

<sup>51</sup> Id., at 21050.

<sup>52</sup> Derived from supplementary information supplied the Commission for C. D. Parker & Co., Inc.

<sup>53</sup> 12 U. S. Code, Sec. 378.

<sup>54</sup> Op. cit. supra, note 52.

<sup>55</sup> Op. cit. supra, note 2, at 20982-3.

<sup>56</sup> Id., at 20981-3.

Q. That is right.

A. With quite a title attached to it, that was given to me by Mr. Tufts.

Q. Now, it became necessary for C. D. Parker & Company to do one of two things, to either get up all of that cash, which was over three million dollars, and turn it back to the trust and let the trusts deposit it in an authorized bank because of the Banking Act of 1933, or do what?

A. Or else.

Q. That's it, or else, and it had to "or else", isn't that so? As I take it, Mr. Bowen Tufts was the one who devised the ingenious scheme of taking this three million dollars, if he only had it, and labeling it what? \* \* \* "Funds reserved for the purchase and sale of portfolio securities under order," was that correct?

A. That is correct.

Q. That little catch phrase was supposed to catch three million dollars, isn't that so?

A. Well, it went in there.

Q. \* \* \* It was supposed to go in there.

A. That was the idea. To put it in that idea.

In this manner, in circumvention of the Banking Act of 1933, the sponsor was able to retain, and even slightly increase, the cash funds of the three investment companies that it held. By December 31, 1935, the sponsor was indebted to the three investment companies in the aggregate sum of \$3,304,776.62. Actually, C. D. Parker & Co., Inc. was insolvent, and, with its ensuing bankruptcy, virtually the entire amount of these "deposits" was, in the opinion of Mr. Stanwood, lost to the stockholders of the investment companies.<sup>57</sup>

According to the books of the investment company, on December 31, 1935, out of the net worth of \$2,714,011.34 of Seaboard Utilities Shares Corporation, C. D. Parker & Co., Inc. supposedly held on deposit for it \$2,034,963.28, constituting approximately 75% of the net worth of the investment company at that time.<sup>58</sup>

In addition to acquiring the cash funds of Seaboard Utilities Shares Corporation as depository, the sponsor pledged securities owned by the investment company and which cost \$155,566.97, for loans to the sponsor which had not been repaid at the time of the bankruptcy.

In addition, securities which cost \$28,425.88, belonging to the investment company, for which C. D. Parker & Co., Inc., was accountable, could not be traced or found. These securities and the cash ostensibly on deposit with the sponsor constituted approximately 90% of the book net worth of the company as of December 31, 1935.<sup>59</sup>

### D. Railroad Shares Corporation

The second investment company, Railroad Shares Corporation, sponsored by C. D. Parker & Co., Inc. was organized in Massachusetts on July 3, 1929, within four months after the organization of Seaboard Utilities Shares Corporation.<sup>60</sup>

C. D. Parker & Co., Inc. formed a syndicate to market the shares of Railroad Shares Corporation, and followed the same plan employed

<sup>57</sup> Id., Commission's Exhibit No. 3235; see also id., at 21020, 21023, 21025.

<sup>58</sup> Id., Commission's Exhibit No. 3232.

<sup>59</sup> Id., at 21021, and Commission's Exhibit No. 3233. Mr. Stanwood, the accountant, testified that the stockholders of the investment company are unlikely to recover any portion of the contributed capital:

Q. So that you can virtually say that the stockholders lost every penny of their contributed capital in the Seaboard Utilities Shares Corporation?

A. That is right.

<sup>60</sup> Op. cit. supra, note 2, at 20921.

in the sale of the stock of the first investment company.<sup>61</sup> Similarly, the sponsor employed the same methods to attain complete domination of this investment company and its assets. As in the case of the first investment company, Railroad Shares Corporation entered into a management contract with the sponsor under which it paid no compensation. This contract was set up on its books as an asset at a value of \$250,000.<sup>62</sup>

The syndicate, composed of the sponsor and dealers, distributed the shares at prices exceeding \$10 each, and paid into the treasury of Railroad Shares Corporation \$10 for each share sold. The excess was retained as payment for marketing the shares.<sup>63</sup> The syndicate apparently had a commitment, and the sponsor and the various dealers as members had participating commitments.<sup>64</sup> Approximately six months after the organization of the investment company, C. D. Parker & Co., Inc., as manager of Railroad Shares Corporation common stock account, released the various dealers of the syndicate and itself from any obligation.<sup>65</sup>

The published financial statements purported to disclose that 1,000,000 shares were issued and outstanding and that the contributed capital was \$10,000,000.<sup>66</sup> In fact, the actual contributed capital was \$6,767,000.<sup>67</sup> The basis of the representation that \$10,000,000 had been received by the investment company from the sale of its shares was the fact that a so-called note for \$8,000,000 payable to the investment company had been executed and \$2,000,000 had been paid in cash to the investment company. Against this the investment company issued 1,000,000 shares, but retained 800,000 shares as collateral

<sup>61</sup> Id., at 20912.

<sup>62</sup> Id., Commission's Exhibit No. 3227.

<sup>63</sup> Id., at 21009. The amount of the profit to C. D. Parker & Co., Inc. has not been disclosed.

<sup>64</sup> Id., at 20914.

<sup>65</sup> Id., at 20915-7 and Commission's Exhibit No. 3226. The letter of release dated December 78, 1929 stated (id., Commission's Exhibit No. 3226): "As managers of Railroad Shares Corporation Common Stock Account dated September 5, 1929, we wish to advise that the account is in a substantial short position taking into consideration commitments made by various banking houses, dealers, etc., to whom the account has confirmed sales. In view of the existing market situation C. D. Parker & Company, Inc., as managers of the account, have determined it to be advisable to cooperate with those who have made commitments to purchase shares from the account and have not taken down the shares committed for by agreeing to a cancellation of one-half of the commitments for shares which have not been taken down and paid for, plus an extension of sixty days to all houses in which the remaining half of the commitments may be taken down and paid for, with a further extension of sixty days upon the understanding that at any time during the second sixty-day extension, the managers may demand that the uncanceled portion of the commitment be taken down and paid for on five days' notice, and that upon failure of any house to take down and pay for the uncanceled commitment the account may cancel the same."

Subsequently, in a second letter dated December 20, 1929, it was stated (ibid.): "In view of the fact that Railroad Securities (Shares) Corporation still has a substantial amount of cash, we can see no reason for imposing any loss on the members of the Syndicate which would merely operate to supply the Railroad Shares Corporation with additional cash. In our opinion, the entire undelivered balance of stock bought at original prices should be cancelled. This cancellation could first be made by Railroad Shares Corporation to C. D. Parker & Company, which will eliminate your liability, and you in turn could cancel these sales to the members of the Syndicate. This would not impose any loss either on Railroad Shares Corporation or the members of the Syndicate and any loss to you would be a loss of your profit on the transaction."

<sup>66</sup> Op. cit. supra, note 2, at 21007, 21012, and Commission's Exhibit No. 3231.

<sup>67</sup> Id., at 21037 and Commission's Exhibit No. 3244.

for the payment of the note.<sup>68</sup> The procedure was to reduce the amount of the note as the syndicate succeeded in disposing of the shares.<sup>69</sup> Of the 1,000,000 shares issued, all but 323,300 shares had been sold, and consequently the original \$8,000,000 note was reduced to \$3,233,000 and a new note executed.<sup>70</sup>

Railroad Shares Corporation included the note of \$3,233,000 in its financial statements under assets in an item entitled "Collateral Loans." The report of the financial condition of the investment company as of 1930 contains the item "Cash and Time Loans secured by Collateral, \$3,532,518.81."<sup>71</sup> Concealed in that item was the note, at that time reduced to \$3,233,000.<sup>72</sup> Mr. Stanwood, in explanation of this method of carrying the \$3,233,000 note and approximately \$200,000 in cash as a single item in the financial statement, testified:<sup>73</sup>

Q. And yet there was only \$200,000 there, isn't that so? In cash?

A. It seems so.

Q. And that item is represented by the note which the sponsor gave and it was collateralized by the very stock of the company itself, isn't that true?

A. That is right.

\* \* \* \* \*

Q. Isn't it a fact that in reading that statement which was issued by you, this balance sheet, you could not tell for the life of you that \$3,000,000 worth of that stock had not been paid for?

A. Well, it all depends. You mean paid for in cash?

Q. Now you refer to it as a time loan. You know it is not a time loan.

A. At that time it was.

Q. Was it changed later?

A. The whole document was changed from time to time.

Q. That is what I was trying to get from you originally. You say that the note was changed?

A. I believe so, in the wording.

Q. And the wording changed that note, so much so that it became no obligation of any kind on the part of C. D. Parker & Company to pay one penny of that note, isn't that so?

A. That is the way it ultimately worked out on the \$3,300,000.

Q. Because by December 31, 1930, certainly C. D. Parker & Company was not going to pay \$10 per share for that stock to the trust was it?

A. No.

Q. But still it was there as cash and time loan secured by collateral?

A. The shares were issued for that.

Q. Well, if the shares were issued for that note, the shares couldn't have been security for the note—the shares couldn't have been collateral for it?

A. The transfer agents showed those shares as issued and outstanding and I couldn't very well disagree with them.

This note of \$3,233,000, secured by the unsold shares of the investment company,<sup>74</sup> contained a provision that payment was to be made only if the syndicate succeeded in selling the collateral.<sup>75</sup> At the option of the sponsor, the note was renewable every six months, and constituted practically a perpetual call on the capital stock of the

<sup>68</sup> Id., at 21008.

<sup>69</sup> Id., at 21007-9.

<sup>70</sup> Id., Commission's Exhibit No. 3244 and *Moody's Manual of Investments, Banks, etc.*, 1935, p. 1604. The note was signed "Railroad Shares Corporation Common Stock Account, September 5, 1929, by C. D. Parker & Co., Inc., Mass., by Bowen Tufts, Vice President, by C. R. Adams, Director."

<sup>71</sup> Op. cit. supra, note 2, at 21011 and Commission's Exhibit No. 3231.

<sup>72</sup> Id., at 21011-2.

<sup>73</sup> Id., at 21007, 21011-13.

<sup>74</sup> Id., at 20918-9, and derived from supplementary information supplied the Commission for C. D. Parker & Co., Inc.

<sup>75</sup> Op. cit. supra, note 2, at 21002.



investment company at \$10 per share.<sup>76</sup> This unilateral arrangement did not require the sponsor to take down stock from the investment company if the price was below \$10 but permitted the sponsor to acquire stock from the investment company at \$10 per share even though the market price was above \$10.<sup>77</sup> Although the note, as reduced to \$3,233,000, was carried on the books of the investment company as an asset under "collateral loan," the sponsor, in fact, never paid this note in its reduced amount, because it apparently never succeeded in disposing of any of these collateral shares.<sup>78</sup>

The deception of the public with respect to this transaction is illustrated by the letter of complaint of George A. Hume, a stockholder. Mr. Hume's attorney wrote to Mr. Henry, a dealer-director of the investment company, on June 4, 1934, as follows:<sup>79</sup>

We are informed that in purchasing these shares Mr. Hume relied upon a statement of the directors of that corporation in ascertaining the value of its stock. In the assets column of this statement was the figure \$3,233,000 carried as "collateral loan."

It is our understanding that this was not a "collateral loan" but represented shares of the corporation which the brokers who were engaged in selling such shares in the open market had been unable to purchase in accordance with the terms of their agreement.

Four days later, after Mr. Henry had replied that he was unaware of the facts, the stockholder, through his attorney, wrote to Mr. Henry as follows:<sup>80</sup>

The situation, so far as my client (George A. Hume) is concerned is as follows:

In the early part of 1931, he received a financial statement of the corporation showing "cash and time loans secured by collateral \$3,532,519" and a later statement showing "cash and time loans secured by collateral \$3,515,319.80." As a matter of fact the corporation had cash to the extent only of about \$200,000 and the balance represented unsold treasury shares of the corporation of a face value of about \$3,300,000.

Mr. Henry communicated his concern over this matter to Bowen Tufts, who gave the following explanation of the item "collateral loan":<sup>81</sup>

For your information, as a Director of the Company, I wish to advise that this item has appeared in all Balance Sheets of the Company published since February 1, 1930, the effective date of the loan. All such balance sheets have been prepared by the public accountants auditing the books of the Company, and I am advised that the item has been designated as "collateral loans" in accordance with usual and proper accounting methods.

The present amount of the item "collateral loans" which appears in the balance sheet of the Company represents the balance due to Railroad Shares Corporation on a loan made to the Syndicate which marketed and distributed the shares of the Corporation. As the Common Stock of the Company which was pledged as collateral for the payment of the loan has been sold and distributed by the Syndicate, the loan has been proportionately reduced.

The amount of the loan does not exceed the amount paid to the Company for the Shares which are pledged as collateral on the loan, and which Shares have never been distributed to the public by the syndicate. As the Shares have been distributed, the same have been released from the collateral and the loan proportionately reduced.

<sup>76</sup> Id., at 21003.

<sup>77</sup> Id., at 21003-4.

<sup>78</sup> Id., Commission's Exhibit No. 3242.

<sup>79</sup> Id., Commission's Exhibit No. 3230.

<sup>80</sup> Ibid.

<sup>81</sup> Ibid.

Mr. Stanwood, however, admitted that the stockholders had the right to believe that the company was entitled to that amount in cash and that they were misled by the term "collateral loan."<sup>82</sup>

Q. Now, obviously somebody was misled by this \$3,300,000 transaction, isn't that so?

A. It must be.

Q. He [the stockholder] certainly had the right to believe that the company actually had that cash coming to it, didn't he?

A. It seems so.

Q. There is no question about that.

A. No.

Following the procedure adopted in dealing with the first investment company, the sponsor had possession of most of the cash deposits of Railroad Shares Corporation. Certificates of deposit were issued by C. D. Parker & Co., Inc., as in the case of Seaboard Utilities Shares Corporation, although the financial statements did not specify that they were issued by the sponsor and not by a bank.<sup>83</sup> So, too, when the Banking Act of 1933 was passed, the sponsor evaded the law by changing the designation of these deposit accounts.<sup>84</sup> On December 31, 1935, the sponsor held cash of the investment company, amounting to \$893,378.51.<sup>85</sup> Mr. Stanwood testified:<sup>86</sup>

Q. I say that C. D. Parker & Company in December 1935 had \$893,378.51 in that so-called special account that was created after the Banking Act was passed?

A. Right.

Q. And the shareholders of Railroad Shares Corporation have no hope or expectancy of ever receiving any part of that money, isn't that so?

A. I doubt it.

The sponsor, as in the case of Seaboard Utilities Shares Corporation, converted \$22,299.04 of portfolio securities of Railroad Shares Corporation by hypothecating them for its own loans. These loans were not paid and the securities were sold to satisfy the debt.<sup>87</sup>

While the books of Railroad Shares Corporation as of December 31, 1935, indicate a net worth of \$4,183,519.46, this, of course, must be diminished by the previously described item of \$3,233,000 carried as an asset under "collateral loans" and for which apparently no recovery is possible. Of the balance, \$893,378.51 consisted of claims against the bankrupt, C. D. Parker & Co., Inc., for cash deposits made by the investment company and \$22,299.04 consisted of the securities converted by the sponsor. The remainder of \$34,841.91 comprised miscellaneous items.<sup>88</sup> The accountant, A. T. Stanwood, stated that it was doubtful that the stockholders would recover any part of their original investment.<sup>89</sup>

### E. Utilities Hydro & Rails Shares Corporation

Prior to the market break in October 1929, C. D. Parker & Co., Inc. had succeeded in selling to the public \$23,250,000 of the securities of the two investment companies it had organized and managed. The

<sup>82</sup> Id., at 21007.

<sup>83</sup> Id., at 20967, et seq.

<sup>84</sup> Id., at 20981-2.

<sup>85</sup> Id., Commission's Exhibit No. 3234.

<sup>86</sup> Id., at 21023.

<sup>87</sup> Id., at 20124.

<sup>88</sup> Id., at 21022 and Commission's Exhibit No. 3234.

<sup>89</sup> Id., at 21024.

sponsor then contemplated a third investment company, which was to exceed in size the two previously organized, and incorporated Utilities Hydro & Rails Shares Corporation in Delaware on November 5, 1929, with 15,000,000 shares of authorized common stock of no par value.<sup>90</sup> The third venture, however, was not launched until shortly after the market break, and this third investment company realized only \$1,573,508.80 from the sale of its stock issue to the public.<sup>91</sup>

The same procedure was used in selling the shares of this company as was employed in the case of the first two companies, with the additional fact that option warrants were included with the offering of stock. The sponsor likewise resorted to the same means to preserve its control of this investment company, including the customary twenty-year management contract. This management contract, under which no compensation was to be paid to the sponsor, was set up by the investment company as an asset with a value of \$100,000.<sup>92</sup>

As with the first two investment companies, C. D. Parker & Co., Inc. acted as depository of the funds of this company. The special accounts created after the National Banking Act of 1933 amounted to \$376,434.83 on December 31, 1935, at which time the net worth of this investment company was \$513,425.86.<sup>93</sup> The sponsor, as in the cases of the earlier companies, also used portfolio securities of the Utilities Hydro & Rails Shares Corporation which cost \$56,961.58 as collateral for loans to the sponsor.<sup>94</sup> The \$376,434.83 which the sponsor supposedly held as depository for the investment company and the value of the converted securities amounted to approximately 84% of the net worth of the company as of December 31, 1935, according to the books of the company.<sup>95</sup> The accountant, A. T. Stanwood, testified that the stockholders could not expect to salvage any part of their investment in this company.<sup>96</sup>

## F. Relation of Accountant to Accounting Practices and Reports

The derelictions of the sponsor, C. D. Parker & Co., Inc. including the conversions of securities and cash funds, were facilitated, as has been indicated, by the use of certain accounting practices and misleading reports to stockholders. By participating in these practices there is a grave question as to whether the public accountants subordinated their duty to the investors to the desires of the sponsor. When examined regarding the obligations of the accountant to the company, Mr. Stanwood testified as follows: <sup>97</sup>

Q. What did you understand the obligation of an accountant for an investment trust to be when the investment trust hired your firm; to whom were you answerable in your conscience?

A. Mr. Bowen Tufts.

Q. You say you were answerable only to Mr. Bowen Tufts?

A. He engaged us to do this work and make certain examinations of those financial audits only and report solely to him.

<sup>90</sup> Id., at 21037.

<sup>91</sup> Id., Commission's Exhibit No. 3244.

<sup>92</sup> Id., Commission's Exhibit No. 3243.

<sup>93</sup> Id., Commission's Exhibit No. 3237.

<sup>94</sup> Id., Commission's Exhibit No. 3238.

<sup>95</sup> Id., Commission's Exhibit No. 3237.

<sup>96</sup> Id., at 21026.

<sup>97</sup> Id., at 20975.

Q. Now, did you feel any obligation on the part of your firm as accountants to these trusts to the stockholders of these trusts?

A. Only insofar as that information would clear through the manager-director, Mr. Tufts.

Mr. Stanwood further testified:<sup>98</sup>

Q. And when you were paid for them [accounting reports], you were paid with the funds belonging to the trusts?

A. Right.

Q. So that it was the stockholders' contributions to the trust that made your compensation possible?

A. Right.

\* \* \* \* \*

Q. Now, don't you think that in all good conscience you owed them a duty, at least equivalent to that which you owed to Mr. Bowen Tufts?

A. I should say so.

Q. Now, in performing that duty don't you think that the primary obligation on your part was to tell to the stockholders through the instrumentality of your reports exactly what was transpiring with respect to their funds in those trusts in the language of accounting?

A. If it was permitted by the manager director.

Q. You mean that your managing director prohibited you from giving authentic reports and clear and unequivocal reports to the stockholders?

A. No: I did not say that.

Q. Well, what is the insinuation of your last remark?

A. I say that in certain of the wording of our reports that were presented to him, there were certain things that I could not put in there.

Q. For example?

A. For example, you read a footnote a few minutes ago [on a certain balance sheet of one of the investment companies] "certain of these securities." I had the amount of those securities in there.

Q. You did have?

A. I was not permitted to put that in.

The influence on the accountant of the desires of the sponsor is indicated by the fact that balance sheets were sometimes prepared numerous times before Bowen Tufts selected the draft that to his satisfaction reflected the financial conditions of the investment companies. Because numerous documents were prepared for Bowen Tufts' scrutiny, Harold B. Lamont refused to make a positive assertion that a document submitted to him for identification had been used publicly. He stated his reasons as follows:<sup>99</sup>

Q. You don't question the authenticity of this document, do you?

A. I don't know that the document was ever used.

\* \* \* \* \*

The EXAMINER. His question was if you doubted the authenticity of the document which you were being interrogated about. Your answer was you don't know whether it was ever used. I don't think that is in response to that question.

The WITNESS. It is in this way because only those who are familiar with Mr. Tufts would realize there might be ten or fifteen different balance sheets submitted to him at different times and perhaps none of them would be used because he might have studied them over and found out they didn't reflect the conditions as they were. He may have gotten hold of a balance sheet that was never used.

Bowen Tufts generally required two reports in connection with each audit, one report for himself containing detailed financial statement and explanatory remarks and one for publication in condensed

<sup>98</sup> Id., at 20975-6.

<sup>99</sup> Id., at 20930-1.

form without the vital explanations. In this connection Mr. Stanwood testified:<sup>100</sup>

Q. And I take it that the influence of Bowen Tufts brought about that situation, which was sad enough, isn't that so?

A. I don't know as I would say "influence." Our first report in the year was in some great detail. I don't believe you have seen any of those, explaining certain of those items, where they were, what they were; and then, of course, for publication they wanted those condensed, and that was sent out.

Q. In other words, \* \* \*

A. It was filed with Mr. Tufts. At the end of every calendar year anyhow, a detailed statement setting forth the story of our each and every asset and liability.

Q. In other words, you had rendered to Bowen Tufts two kinds of reports; [and] incorporated \* \* \* in the body of [one] report \* \* \* [were] the explanatory notes.

A. Yes.

The abbreviated versions published by the investment companies did not reflect the true financial conditions of the affairs of the investment companies, and in no wise enlightened the stockholders, although these condensed reports were certified by the accountant. The accountant testified as follows:<sup>101</sup>

Q. In connection with the reports that were issued to the stockholders, you had no control, you say, over those reports?

A. Those were put out by the company. We furnished reports and then they were condensed for the stockholders.

Q. And those condensed reports are certified by you, though, aren't they?

A. That is right.

Q. I am now talking of these reports which are in evidence—they do not enlighten the stockholders.

A. In certain instances they may not.

Mr. Stanwood acknowledged that the accountant has a grave responsibility as the interpreter of the financial conditions of investment companies and that any explanations of the affairs of investment companies necessarily must be obtained by the stockholders and investing public through the services and medium of the accountant. He testified:<sup>102</sup>

Q. Now, I think you will agree that an investment trust, as a company, cannot do any talking for itself. It cannot talk back to you. It can't make any explanations, and the only way you know anything about it is through the instrumentality of its accountants, isn't that so?

A. Yes.

Q. Even Bowen Tufts, in order to know what was transpiring had to call upon you for you to tell him from the examination of the books just where they were, isn't that so?

A. Yes and reports were furnished on that.

Q. That is correct. So that the interpreter for an investment trust is the accountant?

A. Yes.

Q. And when the shareholders paid the accountant out of their funds of the trust to interpret what is transpiring, they expect it to be, in plain English, isn't that so?

A. That makes it easier.

\* \* \* \* \*

Q. Well, you will agree with me that as far as any information given by the reports to them (the stockholders), they didn't know what was transpiring?

A. Those all cleared through the management of the trust.

<sup>100</sup> Id., at 20979.

<sup>101</sup> Id., at 21039-40.

<sup>102</sup> Id., at 20984-5.

Q. I am not taking issue with you and I am not laying any blame at your door and I am not absolving you. I am asking you the fact. It is a fact that they didn't know?

A. Not from those reports, they didn't know the details, unless other details went out from the management that I wasn't aware of.

Q. And you felt sure that it would not go out?

A. I had an idea.

The accountant's failure to check physically the possession of the portfolio securities of the investment companies enabled the sponsor to conceal its conversion of these securities. As confirmation of physical custody of portfolio securities, the accountant accepted letters of confirmation from C. D. Parker & Co., Inc. as to the investment company securities in its custody as if they were the equivalents of letters of confirmation from a nonaffiliated bank.<sup>103</sup> The accountant justified his position by claiming that it was not part of his job to go behind the letters of confirmation and physically check the securities, although the letters of confirmation came from the sponsor and manager of the investment companies, whose transactions with the companies had to be checked. Mr. Stanwood stated:<sup>104</sup>

Q. Well, anyway you can see the danger of allowing securities belonging to an inanimate trust company, to be in the hands of any one particular individual without having some one chargeable with the responsibility of checking the physical possession of those securities.

A. I don't believe that it is any part of an accountant's job. If he gets a letter from a reputable house and they state they are holding them, it is good enough for me.

The actual financial conditions of the investment companies were concealed not only from the stockholders but also from the directors, for they received only the same financial statements which were sent to the stockholders.<sup>105</sup>

### G. Receivership of the Investment Companies

Early in 1935, a receiver was appointed for the three investment companies, as well as for C. D. Parker & Co., Inc.<sup>106</sup>

The total capital actually received by the three investment companies amounted to \$24,865,508.80, although the investors paid substantially more for the stock of the companies.<sup>107</sup> Over the period of their existence \$4,006,075.57 had been returned to investors in the form of dividends and repurchases of stock.<sup>108</sup> As of December 31, 1935, the net assets, as shown on the books of the three companies, were \$4,177,956.66.<sup>109</sup> Of this amount \$3,304,776.62 was the amount of cash deposited with the sponsor and \$234,827.59 was the value of the converted securities, both of which sums represent probably worthless claims against the bankrupt C. D. Parker & Co., Inc. The remaining items carried as assets, valued on the books of the investment companies at cost, amounted to \$638,352.45. The record does not disclose what recovery, if any, will actually be realized by the stockholders by virtue of these claims and assets.

<sup>103</sup> Id., at 20992.

<sup>104</sup> Id., at 20993.

<sup>105</sup> Id., at 21050-1.

<sup>106</sup> Bowen Tufts died in April 1935. Arthur F. Bickford was appointed as receiver of the three investment companies shortly thereafter. (Id., at 20995, 21000.)

<sup>107</sup> Id., Commission's Exhibit No. 3244.

<sup>108</sup> Ibid. \$2,334,604.08 represents the amount of dividends; \$1,671,471.49 represents the amount expended in the repurchase of stock by the investment companies.

<sup>109</sup> Ibid.

### III. OILS & INDUSTRIES, INC. (FORMERLY KNOWN AS OIL SHARES INCORPORATED)

#### A. Summary

Oils & Industries, Inc. was organized as Oil Shares Incorporated in 1928 and approximately \$13,200,000 was paid by investors for units of its preferred and common stock. After giving effect to repurchases by the company of its own stock for \$6,250,000 and dividends paid of \$1,600,000 by 1935, the public's net investment amounted to approximately \$5,400,000. By December 31, 1935, the investment company's net assets totaled \$928,000, indicating a realized and unrealized loss of more than \$4,000,000 to its stockholders.

Until October 1931, the investment company was sponsored and controlled by Pettigrew & Meyer, Inc., although this fact was not specifically disclosed to the stockholders. Prior to the public sale of the investment company's stock, a wholly-owned corporation of the sponsor obtained a contract to manage the investment company for a term of nine years at a monthly fee of 1/24 of 1% of the investment company's net assets, plus 20% of the profits in excess of \$1.50 per share on the common stock.

Early in 1930, because no market for its stock existed, the investment company amended its charter to permit redemption of the units in 500-unit lots at 91% of their asset value and agreed, without knowledge of the stockholders, to pay the sponsor the remaining 9%.

By October 1931, the pecuniary emoluments accruing to the sponsor from its association with the investment company amounted to \$674,700. In October 1931, when the management fees had diminished, as a result of the "drying up" of the trust caused by the redemption of its stock, the sponsor, without informing the stockholders, agreed to sell the management contract for \$145,000 to Holman, Rapp & Co., a Philadelphia investment banking firm, which also agreed to purchase from the investment company 10,000 units of its securities for \$167,000.

Holman, Rapp & Co. was acting on behalf of Thomas Watson, Joseph Herzberg and Montifiore Kahn, who did not possess the funds to fulfill the obligations which Holman, Rapp & Co. had contracted on their behalf. This group, by representing that it was to acquire control of Oils & Industries, Inc., succeeded in inducing a bank to lend the investment company \$177,000, to be repaid as soon as control was obtained. This group arranged the closing of the contracts with the sponsor and the investment company in the offices of the bank, where an official of the bank exhibited a cashier's check for \$167,000 payable to the investment company for the 10,000 units and delivered to the sponsor a cashier's check for \$10,000 as part payment on account of the management contract. The check for \$167,000 was deposited to the account of the investment company in the bank, which immediately applied it to the reduction of the loan of \$177,000.

The existing board of directors of the investment company resigned and was replaced by nominees of the Watson group. Once in control, this group liquidated a portion of the portfolio of the investment company and used the proceeds to satisfy the balance of the bank's loan of \$10,000 and pay the sponsor \$135,000 still due on the purchase price of the management contract. Within a short time after acquisition of control of the investment company, this group had defrauded the investment company of \$284,000 of which only \$15,000 had been recovered as at the date of the Commission's public examination.

Upon discovery of the "fraudulent conduct" of the Watson group, the old board of directors assumed the management of the investment company until May 1932, when, again without consulting the stockholders, the board appointed Arthur S. Kleeman, the president of Home and Foreign Securities Corporation, another investment company, as president of Oils & Industries, Inc., and permitted him to appoint a majority of a new board of directors. Opposition arose to Mr. Kleeman's management and, in order to remove this opposition, Mr. Kleeman induced David Milton, president of The Equity Corporation, an investment company, to have one of his companies purchase the opposing block of stock. Thereafter Mr. Milton's nominees constituted half of the board of the investment company.

By 1934 the David Milton interests had acquired approximately 40% of the stock of Oils & Industries, Inc. In order to prevent the contemplated absorption of Oils & Industries, Inc. by The Equity Corporation by means of an exchange offer of stock, Mr. Kleeman caused his Home and Foreign Securities Corporation



to purchase the David Milton holdings at a price in excess of their asset value. In order to obtain cash to make this purchase, Home and Foreign Securities Corporation, without knowledge of its minority stockholders, liquidated virtually its entire portfolio and borrowed \$360,000.

Thereafter Mr. Kleeman utilized his control to effect a recapitalization of the investment company, which enabled Home and Foreign Securities Corporation to obtain from Oils & Industries, Inc. the necessary funds to repay the loan of \$360,000. Although previously the preferred stock which had been originally issued by Oils & Industries, Inc. was eliminated to remove dividend arrearages by reclassifying such preferred stock as common, the new recapitalization plan authorized the issuance of new preferred stock, without voting power, to be distributed to the stockholders as a stock dividend, redeemable by the company at 95% of their asset value in 1,000-share lots only and for a period of three weeks. The stockholders approved this plan and Home and Foreign Securities Corporation redeemed all of the new preferred stock it acquired and applied the proceeds to repay the balance of the bank loan of \$360,000. No other stockholder tendered, or apparently was in a position to tender, 1,000-share lots of new preferred stock for redemption. Since the new preferred stock had no voting power, Home and Foreign Securities Corporation's 40% control of Oils & Industries, Inc. was not disturbed.

Although the stockholders of Oils & Industries, Inc. had by the end of 1935 suffered realized and unrealized losses in excess of \$4,000,000, the four different groups which successively controlled it were enabled to derive large profits, directly or indirectly, from their association with the investment company.

## B. Organization

Oils & Industries, Inc., an investment company, was incorporated as Oil Shares Incorporated in Maryland on February 18, 1928, under the sponsorship of Pettigrew & Meyer, Inc.,<sup>1</sup> which had done extensive research in oil company securities.<sup>2</sup> The connection of the sponsor with the investment company was not disclosed in the prospectus of the company or revealed to stockholders in any statement or report.<sup>3</sup> Nevertheless, the sponsor was in actual control of the company until October 1931.

## C. Management Activities

On March 29, 1928 the investment company entered into a management contract with Petroleum Research Corporation, all of the stock of which was owned by the sponsor through an intermediate holding company.<sup>4</sup> The manager was to act as broker for and to aid in the selection of the investments of Oils & Industries, Inc. for a period of nine years, ending on December 31, 1937, and was to receive as compensation a monthly fee equivalent to 1/24 of 1% of the capital, surplus, and undivided profits of the investment company, and 20% of all dividends in excess of \$1.50 per share paid on the common stock. In addition thereto, the sponsor was to receive at the expiration of the management contract 20% of the undistributed profits in excess of \$1.50 per share on the common stock per annum and 20% of all appreciation in the value of the assets of the investment company,

<sup>1</sup> Public Examination, Oils & Industries, Inc., at 14115 and Commission's Exhibit No. 1425. The change from Oil Shares Incorporated to Oils & Industries, Inc., was made on April 17, 1934. (Id., at 14115.)

<sup>2</sup> Id., at 14113.

<sup>3</sup> Id., at 14117 and Commission's Exhibit No. 1427.

<sup>4</sup> Id., at 14132 and Commission's Exhibit No. 1435. Petroleum Research Corporation was wholly owned by Petroleum Management Corporation which in turn was wholly owned by Pettigrew & Meyer, Inc. (Id., at 14131.)



which payment, however, was subject to diminution to the extent of 20% of any depreciation in the value of the assets.<sup>5</sup>

Todd M. Pettigrew and Joseph Meyer, Jr., both of whom owned all of the stock of Pettigrew & Meyer, Inc., did not become directors of Oils & Industries, Inc. but personally selected the entire board of directors.<sup>6</sup>

The stock of the investment company consisted of preferred stock of par value of \$50 per share, redeemable at \$52.50 per share plus accrued dividends and common stock of no par value, each having equal voting rights.<sup>7</sup> On April 9, 1928, the investment company entered into a contract with P. H. Whiting & Co., Inc., by which the latter agreed to distribute the investment company's shares in units consisting of one share of preferred stock and one share of common stock.<sup>8</sup> Ultimately, the public purchased 181,000 units for approximately \$13,212,000, of which \$1,090,000 or over 8% was retained as gross commissions by the distributors of the securities to the public.<sup>9</sup> Of these gross commissions, \$56,700<sup>10</sup> was paid to the sponsor for its services in disposing of a block of the company's unit in Europe<sup>11</sup> and the remainder was paid to P. H. Whiting & Co., Inc.

## 1. REDEMPTION OF SHARES

Following the crash in the market prices of securities in October 1929, stockholders of the investment company were unable to find a market for their shares. On December 27, 1929, the directors of the investment company, who had been selected by the sponsor, voted to recommend to the stockholders the adoption of an amendment to the certificate of incorporation to permit the redemption of the units of securities in 500-unit lots only, by transferring to redeeming stockholders portfolio securities of a market value, at the date of redemption, equivalent to 91% of the asset value of the units redeemed.<sup>12</sup> On the same day, Petroleum Research Corporation, also controlled by the sponsor, agreed to maintain an open offer to purchase any and all units at 91% of the asset value,<sup>13</sup> and to assist the investment company to resell the redeemed units. In consideration of these undertakings on the part of Petroleum Research Corporation, the invest-

<sup>5</sup> Id., Commission's Exhibit No. 1435.

<sup>6</sup> Id., at 14120-1. The board of directors, some of whom had made substantial investments in the investment company's securities (id., at 14121), included Francis de C. Sullivan, the president of Oils & Industries, Inc., at its inception and a director of the Interborough Rapid Transit Company; J. W. Campbell, chairman of The Credit Clearing House of New York; Francis Henderson, a former vice president of Empire Trust Company of New York; Arnold L. Davis, an attorney; David L. George, an investment banker; Liston L. Lewis, an attorney; and Robert E. Miller, a vice president of The Bank of New York & Trust Company. (Id., Commission's Exhibit No. 1427.) The names of these and other directors and their connections were prominently indicated in the prospectuses used to distribute the investment company's securities. (Ibid.)

<sup>7</sup> Id., Commission's Exhibit No. 1427.

<sup>8</sup> Id., Commission's Exhibit No. 1431.

<sup>9</sup> Id., Commission's Exhibit No. 1437 and reply to the Commission's Questionnaire for Oils & Industries, Inc., Pt. I, Exhibit S.

<sup>10</sup> Op. cit. supra, note 1, at 14128.

<sup>11</sup> Ibid.

<sup>12</sup> Reply to the Commission's questionnaire for Oils & Industries, Inc., Pt. I, Exhibit 7a.

<sup>13</sup> Ibid.

ment company agreed to pay to the former 9% of the liquidating value of all assets redeemed by the investment company itself or purchased by Petroleum Research Corporation and then redeemed by the investment company.<sup>14</sup> This agreement was not mentioned in the written notice of the stockholders' meeting to ratify the amendment to the charter<sup>15</sup> nor was it ever subsequently revealed to the stockholders.

The redemption privilege became effective on April 8, 1930. Prior to that time the investment company had repurchased 11,774 units at a cost of \$767,000. During 1930 and 1931 the investment company redeemed 90,000 units by transferring portfolio securities having a market value of \$5,276,000, a sum equivalent to the full asset value of its own redeemed securities. However, stockholders surrendering these units received only 91% of this sum or \$4,801,000, and Petroleum Research Corporation received the remaining 9%, or \$475,000.<sup>16</sup>

No reason other than the prospect of profits to the sponsor appears to explain the failure to pay the stockholders the full liquidating value. Nor does the record reveal any reason for not dissolving the investment company when its size was reduced to \$1,200,000, and returning all its assets to the stockholders. On this point, Joseph Meyer, Jr., one of the owners of Pettigrew & Meyer, Inc., testified:<sup>17</sup>

Q. Why wasn't it submitted to the stockholders that the trust be liquidated and everybody get 100%?

A. Well, that of course, I don't recall. I don't remember just what was paid or whether that was discussed, but why it was not done, I don't recall at this time.

Q. Throughout the entire study we have never gotten a satisfactory answer as to why these trusts were not liquidated at the time the management was convinced that their operations were unsuccessful, and why it was always necessary to try to inject new life into the dying corpse either by trying to raise new money or having redemption provisions like yours or turning them over to people who were strangers, as far as the stockholders were concerned. You do not remember why they didn't say "Well, we managed it, but we are unsuccessful: let's give the stockholders their money and go home."

A. No. My recollection is that they figured that Oil Shares were no more unsuccessful than anything else at this time.

Q. I am not saying that the other companies should not have been liquidated at the time.

A. I mean other investments.

Q. This was virtually a provision where the trust could be liquidated, because you had no assurance that everybody would not turn in the stock.

A. The only thing I remember was to provide a medium for taking care of the distressed unit holders.

Q. And the distressed unit holders had to pay 9% to avail themselves of the help in their distress.

A. That is right; which was very much better than whatever the secondary market was at that time in the open market.

<sup>14</sup> Ibid.

<sup>15</sup> Id., Exhibit A.

<sup>16</sup> Op. cit. supra, note 1, at 14149 and Commission's Exhibit No. 1437. Joseph Meyer, Jr. of Pettigrew & Meyer, Inc., testified (id., at 14137):

Q. So that after paying 9% [in selling commissions to the original distributors of the company's securities] for the privilege of getting in, and after paying the flat [management] fee, and after giving the management a cut in any profits, if the management was unsuccessful and he [the stockholder] wanted to get out he had to pay 9 percent to get out, isn't that so?

A. That is one angle of it. I think that came up along in—

Q. First, that is the fact, is it not? \* \* \*

A. That is the fact.

<sup>17</sup> Id., at 14158-60.

## 2. EMOLUMENTS TO SPONSORS

Mr. Meyer testified that 9% of the asset value of redeemed shares was awarded to Petroleum Research Corporation to compensate it for the loss of management fees due to the "drying up of the trust" resulting from the redemption of the units:<sup>18</sup>

Q. And yet because the performance was not so good and you had undertaken this obligation under the contract in order to meet expenses this arrangement was made to compensate you for the lack of profit under the Research contract?

A. No; to compensate for the drying up of the trust so to speak, because as the units were turned in there was less compensation earned monthly, and in the meantime the salaries and expenses of the Research organization were running on just the same.

By September 1931, the investment company had returned to its stockholders approximately \$1,536,000<sup>19</sup> by way of dividends and \$5,568,000<sup>20</sup> through repurchases and redemptions of its own securities or a total of \$7,104,000 of the \$13,200,000 originally invested in the company by its stockholders. As at September 30, 1931, approximately \$1,200,000<sup>21</sup> remained of the stockholders' remaining investment of \$6,096,000. In other words, the stockholders had suffered a loss of \$4,896,000, or 80% of their remaining investment in the enterprise.

In contrast to the loss suffered by the investment company's stockholders, the sponsor had derived emoluments of approximately \$674,700 as follows: \$475,000 as commissions on the redemption of the investment company's securities, \$56,700 as selling commissions for placing some of the investment company's units with European buyers, and \$143,000 as management fees from 1928 to September 1931, received through its controlled company, Petroleum Research Corporation.<sup>22</sup>

### D. Sale of Management Contract and Control to Watson, et al.

Because of the redemption privilege accorded to the company's stockholders after April 9, 1930, the investment company's assets began to diminish rapidly as stockholders exercised their right of withdrawal. As Mr. Meyer asserted, the trust was "drying up."<sup>23</sup> Compensation under the management contract held by Petroleum Research Corporation, the wholly owned corporation of the sponsor, had diminished sharply after 1929. In 1928 the management compensa-

<sup>18</sup> Id., at 14142.

<sup>19</sup> Reply to the Commission's questionnaire for Oils & Industries, Inc., Pt. II, Schedule 20.

<sup>20</sup> Op. cit. supra, note 1. Commission's Exhibit No. 1437.

<sup>21</sup> Id., Commission's Exhibit No. 1441.

<sup>22</sup> Id., at 14143-4. It will be recalled that compensation under the management contract was fixed at a monthly percentage of the investment company's assets so that the manager was assured at all times of compensation irrespective of the performance record of the investment company. On this point Mr. Johnson, counsel to the investment company, in reply to a question to Mr. Meyer, testified (id., at 14152):

Q. Throughout this entire examination, Mr. Meyer, the thought keeps cropping up in my mind "How about the stockholder in this position." The managers assured themselves without the obligation of investing one dollar in this picture, of a flat fee regardless of their performance, isn't that so? First, isn't that so for the period when the agreement was to terminate?

A. Regardless of the results they had to perform.

<sup>23</sup> Id., at 14142.

tion was \$30,378.00; in 1929, \$59,052.62; in 1930, \$39,520.71.<sup>24</sup> In 1931, the year after the redemption privilege became effective, management fees amounted to \$13,594.17. By September 1931, the net assets of the investment company totaled \$1,200,000, which indicated a management fee of a maximum of only \$6,000 for 1932.

Petroleum Research Corporation found it difficult to replenish the investment company's diminishing assets by resales of the redeemed units. As a result, by the spring of 1931, the sponsor, although not anxious to sell the management rights held by Petroleum Research Corporation, at least was not unwilling to do so. Mr. Meyer testified:<sup>25</sup>

Q. Now were you prone or were you inclined to sell your management contract at that time?

A. Oh, I wouldn't say that; not definitely so.

Q. Did you have a sense of futility or despair that would seem to be prevalent among most of the investment experts who were managing investment trusts at that time?

A. No, I wouldn't say so.

Q. You were not, you say, definitely seeking to sever your connection with the investment trust because you were discouraged with the performance?

A. No, sir.

Q. Although you weren't particularly pleased with the performance?

A. Oh, we were all worried in those days.

Although the compensation receivable under the management contract was steadily declining, the contract, nevertheless, placed the sponsor in an impregnable position with reference to control of the investment company. No dissolution of the investment company or change in its management could occur without compensating Petroleum Research Corporation for the loss of its management contract. Thus Mr. Meyer testified:<sup>26</sup>

Q. No person was going to make a substantial investment in that situation with a management contract outstanding whereby you were to get payments and participate in the earnings of the trust, isn't that so?

A. Oh, probably not.

Q. Isn't that right?

A. Of course, that depends upon the temper of the group.

Q. So that at least in any negotiations which looked to extrication of the stockholders from their predicament, involving a change of management, your management contract at least was an impediment to that transfer of control or change in management.

A. Certainly. Any group would have to give it serious consideration.

Q. That is right, and this management contract was signed, in force and effect before the units were sold to the public. Now, you said [to the stockholders] "you will take it this way or you can't come in"?

A. Yes; correct.

Q. But if you did come in, and if the situation did arise where it was to the best interests of stockholders that there be a change of management, they could do nothing about it if the new interests desired to oust the Petroleum Research Corporation unless the new interests took care of the Petroleum Research Corporation, isn't that so?

A. Still of course, it is like any other contract. If the service was not performed, they could sue for cancellation.

As a consequence of the "control" value of the management contract, groups which desired to acquire control of the investment com-

<sup>24</sup> Id., at 14143-4.

<sup>25</sup> Id., at 14176-7.

<sup>26</sup> Id., at 14147-8.

pany for their own purposes apparently were willing to pay a substantial price for the contract.<sup>27</sup>

Control of the investment company was acquired by Thomas H. Watson, Montifiore Kahn, and Joseph Herzberg, who were without substantial funds<sup>28</sup> but nevertheless successfully acquired control by the use of the investment company's own funds. In the spring of 1931, Mr. Watson, ostensibly the agent for others,<sup>29</sup> approached Pettigrew & Meyer, Inc., to negotiate for the purchase of the stock of Petroleum Research Corporation, which, as has been stated, actually held as its only asset the management contract with Oils & Industries, Inc., and by September of 1931 Mr. Watson offered to pay \$145,000 for such stock. That this offer was in excess of the intrinsic value of the management contract is evident from the fact that, based on the value of the assets of the investment company at that time, the contract holder would receive annual compensation at the rate of \$6,000 or a total of \$36,000 for the remaining six years of the term. The prospect of a rise in security prices which would increase the assets of the investment company, and therefore the amount payable under the management contract, seemed to be remote at that time. And although Mr. Meyer contended that Petroleum Research Corporation was credited by the investment company with the sum of \$76,000<sup>30</sup> on account of its contractual interest in the undistributed profits of the investment company, such sum was payable at the end of the term of the management contract and was subject to reduction at its expiration to the extent of 20% of the depreciation of the investment company's portfolio. As has been indicated, by September 1931 the net investment of \$6,096,000 of the stockholders in the investment company had depreciated 80% or by \$4,896,000.

Both the sponsor and the directors of the investment company demanded the names of the principals represented by Mr. Watson. The board of directors led by Mr. Sullivan, president of the investment company, also indicated to Mr. Watson that a transfer of the management contract would be sanctioned only to parties who would also pur-

<sup>27</sup> By the spring of 1931 other investment companies evinced an interest in acquiring control of Oils & Industries, Inc. Pettigrew & Meyer, Inc. conducted negotiations (id., at 14175) with Arthur Kleeman, the president and largest stockholder of an investment company known as Home and Foreign Securities Corporation. (Id., at 14791.) Mr. Kleeman testified that he discontinued his negotiations because the price asked by Mr. Meyer for the management contract was "far out of line." (Public Examination, Home and Foreign Securities Corporation, at 14820.) Atlas Corporation, through P. H. Whiting & Co., Inc., the distributors of the securities of Oils & Industries, Inc., also made some attempt to acquire control. (Op. cit. supra, note 1, at 14175; and Public Examination, Atlas Corporation, Commission's Exhibit No. 1982.)

<sup>28</sup> Op. cit. supra, note 1, Commission's Exhibit No. 1444. The exhibit contains the oral opinion of Judge Guy Fake, of the United States District Court for the District of New Jersey, in *Oil Shares, Inc. v. Kahn*, in which, holding the latter civilly liable for the loss suffered by the investment company due to Kahn's and his associates' "fraudulent conduct," the court stated: "These negotiations had their inception, as I gather from the evidence in this case, in the minds of Watson, Herzberg, and Kahn. It is quite apparent from the testimony that they were in no financial position to take over so important and delicate an enterprise; but by virtue of their conspiring and confederating, they were able to put themselves in a position behind respectable houses, which caused such firms as Holman, Rapp & Company and others to permit themselves to be used as agents for the conspirators who remained concealed in the background."

<sup>29</sup> Op. cit. supra, note 1, at 14177-79.

<sup>30</sup> Id., at 14184.

chase a stock interest in the investment company and aid in the public distribution of its redeemed and/or authorized but unissued units of stock.<sup>31</sup>

Messrs. Watson, Herzberg, and Kahn, whose backgrounds, it was subsequently discovered, "would not bear investigation,"<sup>32</sup> then enlisted the services of other individuals to act as principals in the purchase of the stock of Petroleum Research Corporation from the sponsor. Holman, Rapp & Company, a Philadelphia investment banking firm, headed by Val B. Holman, was induced by Mr. Watson and his associates to act as ostensible principal in the transaction.<sup>33</sup> Mr. Holman's cooperation was secured by a promise of a commission of \$12,000 for his services and the presidency of Oils & Industries, Inc.<sup>34</sup> Further, a contract between Holman, Rapp & Company and Oils & Industries, Inc., was to be executed under which the former would become the distributor of the securities of the investment company.<sup>35</sup> Jackson & Curtis, a New York brokerage firm, and Carter, Martindell & Company, a firm of investment counselors, were also enlisted<sup>36</sup> to act as agents representing Holman, Rapp & Company, the ostensible principal in the transaction.<sup>37</sup> Carter, Martindell & Company apparently was promised a management contract with Oils & Industries, Inc., after Messrs. Watson, Herzberg, and Kahn had acquired control.<sup>38</sup> In addition Carter, Martindell & Company and Jackson & Curtis were to receive a joint fee of \$25,000 for their services.<sup>39</sup>

In August 1931, Carter, Martindell & Company and Jackson & Curtis, acting as agents for Holman, Rapp & Company, offered to purchase from the sponsor all of the stock of Petroleum Research Corporation for \$145,000 and agreed to purchase from the investment company 10,000 units of its preferred and common stock at their asset value, \$167,000.<sup>40</sup> Mr. Meyer testified that the price that Holman, Rapp & Company was willing to pay for the management contract did not arouse his suspicion as to the ultimate purpose of the purchasers.<sup>41</sup>

On September 25, 1931, the board of directors of Oils & Industries, Inc., relying on the fact that Holman, Rapp & Company (which the directors had investigated) was the principal in the transaction,<sup>42</sup> approved the sale of 10,000 units of the investment company's stock and the sale of the stock of Petroleum Research Corporation by the sponsor. At the same time Mr. Watson represented to Francis Sullivan, the president of the investment company, that after the passage of control of the investment company to Holman, Rapp & Company, Mr. Sullivan would be employed in an advisory capacity at a salary

<sup>31</sup> Id., at 14188-90.

<sup>32</sup> Id., Commission's Exhibit No. 1439, at 17.

<sup>33</sup> Id., Commission's Exhibit No. 1439.

<sup>34</sup> Id., at 4-5, 13-14.

<sup>35</sup> Id., at 4-5.

<sup>36</sup> Id., at 3, 11.

<sup>37</sup> Id., at 11 and Commission's Exhibit No. 1443, at 26.

<sup>38</sup> Id., Commission's Exhibit No. 1439, at 5.

<sup>39</sup> Id., at 14189 and Commission's Exhibit No. 1439, at 11. C. Shelby Carter, of Carter, Martindell & Company, testified that his firm eventually received \$15,000 and Jackson & Curtis received \$10,000 in commissions for their part in these transactions. (Public Examination, All America General Corporation, at 15775, 15778, 15782.)

<sup>40</sup> Op. cit. supra, note 1, at 14191.

<sup>41</sup> Id., at 14181-14186.

<sup>42</sup> Id., at 14189, and Commission's Exhibit No. 1443 (p. 27).

of \$12,000 per annum.<sup>43</sup> Mr. Sullivan, however, never received this salary.

Holman, Rapp & Company did not intend to use its own funds to provide the approximately \$312,000 required to purchase the stock of Petroleum Research Corporation and the 10,000 units of Oils & Industries, Inc. Messrs. Watson, Herzberg, and Kahn represented to Mr. Holman that they were acting on behalf of a syndicate which had "made a large sum of money running into some millions of dollars through operating in real estate in New York City."<sup>44</sup> Mr. Herzberg told Mr. Holman that in the opinion of the syndicate "stocks were cheap and that anyone who bought at the prevailing market prices would reap a handsome profit over a period of time, and that the syndicate was aware that by buying shares of investment trusts they could get better value for their money than by buying shares of separate corporations because the shares of many investment trusts were selling very much below their liquidating value."<sup>45</sup> In fact, no syndicate existed, and Messrs. Watson, Herzberg, and Kahn did not possess the \$312,000 necessary to effect the shift in control of Oils & Industries, Inc. to themselves.

From time to time the closing of the transaction was adjourned.<sup>46</sup> Finally, Messrs. Watson, Herzberg, and Kahn devised a scheme to effect an ostensible payment for the Oils & Industries, Inc. units and the stock of the Petroleum Research Corporation. They arranged the closing of the transaction in the offices of the Commercial Trust Company of New Jersey in Jersey City on October 9, 1931. Previously, Mr. Watson stated to Edward Groth, a vice president of the Commercial Trust Company of New Jersey, that he and his group were acquiring control of Oils & Industries, Inc.<sup>47</sup> On October 9, 1931, prior to the meeting to close the purchase of the management contract, Mr. Watson requested the bank to lend \$177,000 to Oils & Industries, Inc., as of October 10, 1931. The bank agreed to make the loan and to issue two cashier's checks dated October 10, 1931, one in the sum of \$167,000 and the other, \$10,000. The bank, through its representative at the closing, however, was to keep physical possession of the larger check, merely exhibit it, and then deposit it in an account of Oils & Industries, Inc., which was to be opened in the bank the next day. At 6 p. m. on October 9th, 1931, the closing took place. The \$167,000 cashier's check was exhibited by the bank's

<sup>43</sup> Id., at 14230 and Commission's Exhibit No. 1439, at 13.

<sup>44</sup> Id., Commission's Exhibit No. 1439, at 2.

<sup>45</sup> Id., Commission's Exhibit No. 1439, at 2-3.

<sup>46</sup> Mr. Holman was advised by Messrs. Herzberg and Kahn that the delay in the closing of the transaction was due to the illness of an alleged member of the syndicate they purported to represent, who was a "millionaire several times over" and who appeared at the "settlement of all deals with his pocket check book and would write out checks for large amounts from this small book." On October 6, 1931, Mr. Herzberg informed Mr. Holman, "with a downcast look on his face," that the member had died and that this would cause a little delay as each member of the syndicate would have to put up a little more money. (Id., Commission's Exhibit No. 1439, at 8-9.)

<sup>47</sup> Id., Commission's Exhibit No. 1443, at 50. From the inception of the investment company until July 31, 1931, the Commercial Trust Company of New Jersey had been the depository of the funds and the custodian of its portfolio securities. (Id., at 14214-5.) Apparently Mr. Watson had informed the Commercial Trust Company of New Jersey that on the accession of his group to control of Oils & Industries, Inc. the banking business and the custodianship of its securities would be restored to the bank. (Id., Commission's Exhibit No. 1443, at 51.)



representative to the directors of Oils & Industries, Inc., who thereupon turned over 10,000 units of the investment company's stock to Holman, Rapp & Company. The \$10,000 check was given to Mr. Meyer in part payment for the stock of Petroleum Research Corporation.<sup>48</sup> Pettigrew & Meyer, Inc. agreed to accept Mr. Holman's note payable November 2, 1931, for the \$135,000 balance due on the stock of Petroleum Research Corporation, which held the management contract of the investment company.<sup>49</sup> The \$167,000 cashier's check, after being exhibited to the directors of Oils & Industries, Inc., never left the possession of the bank, and was deposited to an account of Oils & Industries, Inc., in the Commercial Trust Company of New Jersey, opened the next day.<sup>50</sup> The \$177,000 "loan" of Oils & Industries, Inc. from the bank was reduced to \$10,000 on October 10, 1931, by a credit of the \$167,000 check to the account of the investment company.<sup>51</sup> The effect of the transaction with respect to the \$167,000 check was that the bank merely drew this check, debited the account of the investment company, then "deposited" this check and credited the investment company with \$167,000, thus wiping out the loan of \$167,000. It was tantamount to drawing the check, exhibiting it at the closing, and then destroying it.

## 1. CONVERSION OF INVESTMENT COMPANY'S FUNDS BY THE NEW MANAGEMENT

At the closing on October 9, 1931, all the previous directors and officers of Oils & Industries, Inc. resigned and were replaced by Mr. Holman and Mr. Watson and his associates. Mr. Holman became president and Mr. Kahn vice president of the investment company.<sup>52</sup> The stockholders of Oils & Industries, Inc. were informed of this change in the management only after its occurrence.

<sup>48</sup> Id., at 14220-24.

<sup>49</sup> Id., Commission's Exhibit No. 1443, at 29.

<sup>50</sup> Mr. Sullivan, the president of the investment company at the time, testified (id., at 14221-2) :

A. \* \* \* Mr. Groth [vice president of the Commercial Trust Company] said that it was after banking hours and he would deposit the check to the credit of Oil Shares in the Commercial Trust Company.

Q. What business was that of his if it was after banking hours?

A. \* \* \* I claimed that we had no account there, that we had no money in the bank, that it was closed out, and I was told by counsel that the Commercial Trust Company were reputable people and it was quite all right to let Mr. Groth give a receipt.

\* \* \* \* \*

Q. Did anyone say to Mr. Groth, "Just mind your own business; we will deposit the money where we please"? And after all, that was your check.

A. I said that to an extent, but not quite the words.

Q. At any rate, Groth refused to give physical possession of the check.

A. He did.

Q. And he insisted that he retain it and that the account be opened in his bank?

A. He did.

Subsequently Oil Shares Incorporated now known as Oils & Industries, Inc., sued Commercial Trust Company of New Jersey and Mr. Watson and his associates to recover the losses it suffered as a result of the "looting" of its assets by Messrs. Watson, Herzberg, and Kahn on the theory that the bank had conspired with Mr. Watson and his associates to defraud the investment company. The United States Circuit Court of Appeals, however, affirmed the judgment of the Federal District Court of New Jersey absolving the bank from any participation in the conspiracy of Messrs. Watson, Herzberg, and Kahn to defraud Oils & Industries, Inc. (*Oil Shares, Inc. v. Kahn et al.*, 94 F. [2d] 751 [C. C. A. 3rd, 1938].)

<sup>51</sup> Id., at 14242-44, and Commission's Exhibit No. 1443 (p. 39).

<sup>52</sup> Id., at 14224 and Commission's Exhibit No. 1439, at 12.



On October 10, 1931, Messrs. Watson, Herzberg, and Kahn, then in control of Oils & Industries, Inc. proceeded to "loot"<sup>53</sup> the investment company. On that day they borrowed \$200,000 from Redmond & Company, a firm of New York brokers, and used portfolio securities of Oils & Industries, Inc. as collateral.<sup>54</sup> This money was deposited with the Commercial Trust Company of New Jersey for the account of the investment company.<sup>55</sup> The bank deducted \$10,000 on account of the cashier's check, given to Pettigrew & Meyer, Inc. in part payment for the stock of Petroleum Management Corporation.<sup>56</sup> On the same day, National Public Service Corporation, a corporation organized by Messrs. Watson, Herzberg, and Kahn<sup>57</sup> to act as a holding company for Oils & Industries, Inc., received from Holman, Rapp & Co. the 10,000 units of the investment company's stock and delivered to Mr. Holman a cashier's check of the Commercial Trust Company of New Jersey in the sum of \$12,000 for his commission. The \$12,000 check was actually charged against the account of Oils & Industries, Inc.<sup>58</sup> Three days later National Public Service Corporation borrowed \$100,000 from Oils & Industries, Inc. on the security of the 10,000 units of the latter's stock.<sup>59</sup> It will be remembered that Oils & Industries, Inc. did not receive any money for these units, because the investment company's account was debited \$167,000 upon the issuance of the cashier's check and then credited with \$167,000 upon deposit of the check. National Public Service Corporation never repaid this "loan."<sup>60</sup> Of this sum apparently \$25,000 was paid to Carter, Martindell & Company and to Jackson & Curtis for their services.<sup>61</sup>

On October 10, 1931, the investment company paid to Mr. Watson \$10,000 as "legal fees."<sup>62</sup> On October 10 and October 13, 1931, the investment company paid to Mr. Kahn a total of \$14,000 as "advance salary."<sup>63</sup>

Messrs. Watson, Herzberg, and Kahn continued to liquidate the portfolio securities of the investment company and to deposit the proceeds to the credit of Oils & Industries, Inc.<sup>64</sup>

On November 2, 1931, Messrs. Watson, Herzberg, and Kahn delivered to Pettigrew & Meyer, Inc., a cashier's check of the Commercial Trust Company of New Jersey for \$135,000 to complete the payment for the stock of Petroleum Research Corporation,<sup>65</sup> the sum of \$135,000 being charged against the account of the investment company maintained in the bank.<sup>66</sup> Thus, Pettigrew & Meyer, Inc. was paid for its management contract with, and Messrs. Watson, Herzberg, and Kahn obtained control by, the use of the investment company's own funds.

<sup>53</sup> *Oil Shares, Inc. v. Kahn et al.*, 94 F. (2d) 751 (C. C. A. 3rd, 1938).

<sup>54</sup> *Op. cit. supra*, note 1, at 14242-44.

<sup>55</sup> *Ibid.*

<sup>56</sup> *Ibid.*

<sup>57</sup> *Id.*, at 14233; and Commission's Exhibit No. 1443, at 40-41.

<sup>58</sup> *Id.*, at 14244; Commission's Exhibit No. 1439, at 13.

<sup>59</sup> *Id.*, at 14245 and Commission's Exhibit No. 1443, at 41.

<sup>60</sup> *Ibid.*

<sup>61</sup> See note 39, *supra*.

<sup>62</sup> *Op. cit. supra*, note 1, at 14244 and Commission's Exhibit No. 1439, at 19.

<sup>63</sup> *Ibid.*, and Commission's Exhibit No. 1443 (p. 7).

<sup>64</sup> *Id.*, at 14244.

<sup>65</sup> *Ibid.* and Commission's Exhibit No. 1443, at 48.

<sup>66</sup> *Ibid.*

By November 9, 1931, Messrs. Watson, Herzberg, and Kahn had diverted approximately \$284,000 of the funds of Oils & Industries, Inc., to their own purposes.<sup>67</sup> Meanwhile, however, Mr. Holman had been informed concerning the background of these individuals and had become suspicious of them.<sup>68</sup> On or about November 9, 1931, Mr. Holman and his attorneys inspected the books of the investment company, and the duplicity of Messrs. Watson, Herzberg, and Kahn was revealed. Mr. Holman, as president of Oils & Industries, Inc., swore out a warrant for the arrest of Messrs. Watson, Herzberg, and Kahn.<sup>69</sup> Mr. Kahn was arrested but never brought to trial,<sup>70</sup> and Messrs. Watson and Herzberg were never apprehended. In a civil action against Mr. Kahn, brought by the investment company, a judgment for the amount of its losses as a result of his "fraudulent conduct" was obtained,<sup>71</sup> which, however, was never satisfied.<sup>72</sup> The investment company also sued Pettigrew & Meyer, Inc., to recover \$145,000 of the funds of the company which had been paid for the stock of Petroleum Research Corporation. This action was settled for \$50,000.<sup>73</sup> As of April 1, 1937, \$15,000 had been paid on account of the settlement.<sup>74</sup> If it be assumed that the full \$50,000 had been paid by Pettigrew & Meyer, Inc., the losses of Oils & Industries, Inc., due to the "fraud"<sup>75</sup> of Watson, Kahn & Herzberg, will total \$234,000.

It is obvious from the foregoing recital that the liquidity of the assets of investment companies and the comparative ease with which such assets can be diverted to the use of those in control of these companies assisted Messrs. Watson, Herzberg, and Kahn in their "looting"<sup>76</sup> of the assets of Oils & Industries, Inc. As has been indicated, the approval of the stockholders of Oils & Industries, Inc. to the transfer of the management contract or control of the company was not obtained; nor were they apprised in advance of these contemplated shifts.<sup>77</sup> Francis

<sup>67</sup> *Id.*, at 14244.

<sup>68</sup> *Id.*; Commission's Exhibit No. 1439, at 20.

<sup>69</sup> *Id.*, at 14235 and Commission's Exhibit No. 1439, at 19-20.

<sup>70</sup> *Id.*, at 14236.

<sup>71</sup> Oral opinion of Judge Fiske in *Oil Shares, Inc. v. Kahn et al.* (op. cit. supra, note 1, Commission's Exhibit No. 1444); *aff'd* 94 F. (2d) 751 (C. C. A. 3rd, 1938).

<sup>72</sup> Op. cit. supra, note 1, at 14260.

<sup>73</sup> *Id.*, at 14262.

<sup>74</sup> *Ibid.*

<sup>75</sup> See supra, note 71.

<sup>76</sup> See *Oil Shares, Inc. v. Kahn et al.*, 94 F. (2d) 751 (C. C. A. 3rd, 1938).

<sup>77</sup> The United States Circuit Court of Appeals for the Third Circuit in its opinion in *Oil Shares Inc. v. Kahn*, 94 F. (2d) 751 (C. C. A. 3rd, 1938), holding Mr. Kahn and others liable to the investment company for its losses suffered by their "looting" of its funds, by way of *dictum*, stated with reference to the liability of the old directorate which, without consulting the stockholders, turned control of the company over to Messrs. Watson, Herzberg, and Kahn:

The individual members of the old board are not before us and we have no thought of criticizing them unheard, but no one more than they now realize the serious mistake they made. Reference to the date of this transaction would in itself soften criticism of what any board of directors did whose corporation was in dire need of funds to be supplied with fresh capital. Overeagerness to get the money would blind them to the need of looking closely into the source of its supply. Nonetheless, any board which did what this board did would be taking upon itself a grave responsibility. The assets of their corporation belonged to the then stockholders. What the board did was to turn over the assets to the control of a new board without asking for the sanction of the stockholders to whom the assets belonged. Nothing would excuse them from taking this responsibility upon themselves except to have what was done turn out well. If it turned out otherwise, as here, they could not escape deserved criticism. Good intentions would not avail them as a defense.

Sullivan, the former president of Oils & Industries, Inc., when examined on the transfer of control, testified: <sup>78</sup>

Q. You knew, of course, that Petroleum Research Corporation was going to sell its management contract.

A. Yes.

Q. Now, of course, when the stockholders bought this stock, Mr. Sullivan, they bought it in reliance at least that the other members of the Board were going to be on the Board, isn't that so, and that Petroleum Research Corporation had a 10-year management contract, isn't that so?

A. I think they did.

Q. And then one fine morning they woke up and found that everybody on the old Board was not there any more, including the officers?

A. It is quite true. I admit it \* \* \*.

Q. \* \* \* But as far as the stockholders were concerned, without even the slightest intimation in any official way from the corporation, there was a complete change of management, and as soon as the money was turned over the entire old board is out and the old Research Corporation is out and a new corporation and new individuals are in there?

A. I think I will have to admit that.

Q. Although the situation was that as far as the stockholders' position or predicament was concerned, if they wanted to get a new management in there they could not do it because Petroleum Research Corporation had a 10-year contract, isn't that so?

A. I think they did have a 10-year contract; that is true.

\* \* \* \* \*

Now the belief, and I am not going to give any excuse now, the belief was that we were helping the company along to get new money into the organization, to select their own advisory capacity, and to sell additional securities through this house, with that experience I would not do it again. I will answer your question that way.

Q. And also the situation is that there was always a possibility that the belief might be wrong and then the consequences may be very dire, isn't that so?

A. That is right.

Q. That is particularly true, as I say, in an investment trust, because if you turn a steel plant over to anybody he cannot sell it overnight, but he can sell 10,000 shares of steel [stock] overnight, can he not?

A. Yes.

Mr. Sullivan testified further: <sup>79</sup>

Q. Looking back over that experience, Mr. Sullivan, do you get any ideas with respect to what could be done to protect the investor in that instance? He did not know a thing about this, did he? I mean, he did not know a thing about the fact that there was a contemplated change in management there with respect to the old Board of Directors and the officers and with respect to the advisory contract?

A. I feel now that very full information on any particular change in any organization should be put up to the stockholders themselves so that they may have full knowledge before a change.

<sup>78</sup> Id., at 14224-14227. Arthur S. Kleeman, who subsequently became the president of Oils & Industries, Inc., testified (Public Examination, Home and Foreign Securities Corporation, at 14863):

Q. A person's competence and ability will have to be presumed in the first instance?

A. Yes, sir; and frequently it is judged in the light of his performance. If everything works out very fine it is all right, and if not, there is criticism.

Q. But you think not only is it desirable but it may be essential that in view of the particular nature of an investment trust the assets of which are usually in cash or marketable securities, or in liquid form on which it is easy to lay one's hands, that some provision should be made for some weeding-out process of undesirables who are in control of investment trusts; is that right?

A. I feel that very strongly and, of course, I feel there ought to be some way of testing the integrity of a man at the time he becomes a member of the board of directors of an investment trust.

<sup>79</sup> Id., at 14254-5.

Mr. Sullivan testified with reference to the transfer of control to a new group:<sup>80</sup>

Q. But you can visualize that this situation can be one of easy occurrence, isn't that so?

A. Yes; surely it can.

Q. And it can occur more frequently in the investment trust situation than in the industrial corporation because of the liquidity of their assets? All you have to do is to cross the street, get the key to the vault and take the securities out, every nickel of them?

A. Yes.

### E. Transfer of Management to Arthur S. Kleeman

Following the discovery of the "fraud"<sup>81</sup> practiced by Messrs. Watson, Herzberg, and Kahn, the old board of directors again took over the management of Oils & Industries, Inc.; but the changes in the management of the investment company did not cease. On May 16, 1932, the board of directors requested Arthur S. Kleeman, the president and largest stockholder of the Home and Foreign Securities Corporation,<sup>82</sup> an investment company organized by him in 1929, to take over the management of Oils & Industries, Inc.<sup>83</sup> Mr. Kleeman accepted the presidency of Oils & Industries, Inc., at an annual salary of \$6,000,<sup>84</sup> which later was increased to \$8,000 and finally to \$10,000.<sup>85</sup> Although neither Mr. Kleeman nor his investment company, Home and Foreign Securities Corporation, owned a single share of Oils & Industries, Inc., the existing directors permitted Mr. Kleeman to nominate his own slate of directors.<sup>86</sup> All but two of the old directors resigned.<sup>87</sup> Stockholders were informed of this second change in the management of the investment company only after it had occurred.<sup>88</sup>

On July 28, 1933, under Mr. Kleeman's management, and with the approval of the stockholders, the outstanding 82,940 units of preferred and common stock were reclassified into 82,940 shares of common stock,<sup>89</sup> thus changing the capitalization of the investment company. The privilege of the stockholder to redeem his stock in only 500-share lots at 91% of asset value was retained.<sup>90</sup> Later, on April

<sup>80</sup> Id., at 14256-7.

<sup>81</sup> See *supra*, note 71.

<sup>82</sup> Public Examination, Home and Foreign Securities Corporation, at 14791 and 14837.

<sup>83</sup> Id., at 14822.

<sup>84</sup> Id., at 14823.

<sup>85</sup> Id., at 14867.

<sup>86</sup> Id., at 14822.

<sup>87</sup> Id., at 14822-3.

<sup>88</sup> Id., at 14865.

<sup>89</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. 1442, Item 4. The purpose of this amendment was to create a capital surplus of \$1,615,815 by marking down by that amount the stated capital of the investment company's stock as reclassified. From this "surplus," it was possible under the Maryland law to pay dividends. Prior to the recapitalization, the total assets of the investment company were exceeded by its stated capital applicable to its preferred stock, a condition which prevented the payment of dividends on the preferred stock under Maryland law. The recapitalization also eliminated dividend arrearages on the preferred stock. (Public Examination, Home and Foreign Securities Corporation, Commission's Exhibit No. 1519.) Thereafter dividends of 25 cents a share were paid on the common stock as reclassified. (*Ibid.*)

<sup>90</sup> Id., Commission's Exhibit No. 1442, Item 4.

17, 1934, the number of shares required for the exercise of the privilege was increased to 1,000 and the redemption price was raised to 95% of the asset value.<sup>91</sup>

## **F. Transfer of Control to Arthur S. Kleeman and The Equity Corporation**

Immediate opposition developed to Mr. Kleeman's management. A Canadian investment house representing a large group of Canadian stockholders holding a substantial number of shares of the investment company, attempted to gain control.<sup>92</sup> In order to remove this "frankly hostile"<sup>93</sup> group, Mr. Kleeman induced David Milton, the president of The Equity Corporation, to cause one of its subsidiaries, Group Assets, Inc., to purchase the shares of Oils & Industries, Inc. held by the Canadian group, which constituted approximately 40% of the outstanding stock of the investment company and was by far the largest individual stock interest. In November 1933, six representatives of Mr. Milton and his associates were elected to the board of directors of Oils & Industries, Inc.<sup>94</sup> Mr. Milton and his associates were actually in control of Oils & Industries, Inc., although Mr. Kleeman remained as president and he and five of his nominees constituted half of the investment company's board of directors.

### **1. OPPOSITION OF ARTHUR S. KLEEMAN TO MERGER OF OILS & INDUSTRIES, INC. WITH THE EQUITY CORPORATION**

It was neither Mr. Kleeman's intention nor understanding that Oils & Industries, Inc. was to be merged ultimately with The Equity Corporation. Mr. Kleeman testified:<sup>95</sup>

Q. Was it your intention that the Milton interests should ultimately acquire control of this situation, and that they would take over the management of Oil Shares Incorporated?

A. No. There were a great many discussions between Mr. Milton and myself, in which—I do not recall his name——

Q. Ellery C. Huntington?

A. Ellery C. Huntington participated about our cooperating in the further development of Oil Shares Incorporated.

Q. Well, it was not your intention, was it, to have the Milton interests acquire control and ultimately relieve you of the management and take over the management themselves?

A. As a matter of fact, it was not their intention when they came in. There were many discussions about my continuing the management.

Q. The immediate problem was to get the block of stock out of the Canadian hands into the hands of interests that you considered more friendly to your management.

A. Not only friendly, but cooperative.

Whatever may have been the understanding of Mr. Kleeman, Group Assets, Inc. continued to accumulate the stock of Oils & Indus-

<sup>91</sup> Id., Commission's Exhibit No. 1442, Item 6. At the same time the stockholders voted to change the name of the corporation from Oil Shares Incorporated to Oils & Industries, Inc. (Ibid.)

<sup>92</sup> Op. cit. supra, note 82, at 14823-4.

<sup>93</sup> Id., at 14825-7.

<sup>94</sup> Id., at 14827.

<sup>95</sup> Id., at 14825-6.

tries, Inc., and by June 1934 had accumulated 25,000 shares of the capital stock or approximately 44% of the 56,000 shares of the latter's stock.<sup>96</sup> Late in May 1934 Mr. Milton informed Mr. Kleeman that The Equity Corporation intended to make an offer of exchange for the remaining outstanding shares of Oils & Industries, Inc. Ultimately, if the exchange offer was successful, Oils & Industries, Inc. was to be merged with The Equity Corporation.<sup>97</sup>

Mr. Kleeman, having undertaken to rehabilitate Oils & Industries, Inc., and desiring to retain control for "business reasons,"<sup>98</sup> informed David Milton that if an exchange offer were made he would recommend that the investment company's stockholders exercise their privilege of redemption and obtain 95% of the asset value of their stock; and that he would cause a trustee to be appointed to receive and pool for redemption the holdings of stockholders owning less than the number of shares required for the exercise of the redemption privilege. Mr. Kleeman testified:<sup>99</sup>

Q. And there would be no sense in Mr. Milton making the exchange offer as he would wind up only with his own stock.

A. That is true.

Q. So that [it was] this suggestion or threat that they would resort to that proceeding \* \* \* that led Mr. Milton to say that he was willing to talk about the possibility of selling his shares?

A. Well, the word "threat" I do not like in that connection because it has a bad connotation. I thought I was keeping faith with the stockholders if I gave them the same opportunity.

Q. I was not imputing to you any motive.

A. Well, I do not like the word.

Q. The suggestion to Mr. Milton that he might find himself in [the] predicament \* \* \* if he made the exchange offer \* \* \* that he was the only one who would accept the exchange, made him willing to talk about the possible transfer of the Oils & Industries.

A. That is right.

The eventual merger of Oils & Industries, Inc. with The Equity Corporation might have meant the termination of Mr. Kleeman's connection with the investment company.<sup>100</sup> Mr. Kleeman, when examined as to the motives which impelled him to resist the contemplated exchange offer of The Equity Corporation, testified:<sup>101</sup>

Q. \* \* \* Now there were the Milton interests with 25,000 shares of common, which was a controlling block—no doubt about that—and the Milton interests said we are going to make an exchange offer and acquire sufficient of the stock of Oils & Industries to make it part of the Equity picture; isn't that so?

A. Yes, sir.

Q. You virtually said to Mr. Milton, "I don't agree with that, and as far as I am concerned I will redeem my stock and make it possible for other people

<sup>96</sup> Id., at 14827; Public Examination, Oils & Industries, Inc., Commission's Exhibit No. 1442.

<sup>97</sup> Mr. Kleeman testified (op. cit. supra, note 82, at 14828):

Q. So that after the Milton interests acquired substantial interests in that stock, they contemplated making an exchange offer to all the stockholders which would ultimately look to the dissolution or the absorption of Oils & Industries, into the Equity picture?

A. Yes, sir.

<sup>98</sup> Id., at 14829.

<sup>99</sup> Id., at 14833-4.

<sup>100</sup> Mr. Kleeman testified (id., at 14828):

Q. Of course that [the absorption of Oils & Industries by The Equity Corporation] would relieve you of the management of that situation? Isn't that so?

A. They asked me to stay on the board; but I did not think it would make any difference in my salary as I remember it; but it was to become a part of The Equity Corporation eventually or one of their other companies.

<sup>101</sup> Id., at 14869-70.

who concur in my opinion to redeem their stock through the appointment of a trustee."

A. That is right.

Q. Would Mr. Milton say to you, "By what token are you undertaking to stand in my way since you have no stock interest in this situation and we have?" I mean, was there any discussion of your right to control and his right to control?

A. There was a definite statement on my part as to why I took that position. I refer to the first letter sent out to the shareholders when I became president of the company, which was a letter to the effect, if not in so many words, we stated we would try to rebuild the company where the shareholders would get a return and a chance to recover their principal. I didn't want any exchange for securities for anything in the Equity picture that might stop that. Now, I had two reasons for it; one, I wanted to continue the program and see it through, and number two, I felt I should use the opportunity that I had in there to do a constructive piece of work for the shareholders and myself, too. I am not trying to be holy about it, but I had those two objectives, and I think Mr. Milton understood that clearly.

### G. Transfer of Control to Home and Foreign Securities Corporation

In order to remove David Milton and his associates from control, Mr. Kleeman determined to have his investment company, Home and Foreign Securities Corporation, purchase the shares of Oils & Industries, Inc. held by them.<sup>102</sup>

In order to consummate Mr. Kleeman's desire to retain control, Home and Foreign Securities Corporation on June 8, 1934, purchased from Group Assets, Inc.<sup>103</sup> 25,000 shares of the capital stock of Oils & Industries, Inc. at an average price of \$21.41 a share<sup>104</sup> for a total cost of approximately \$535,000. The then asset value of each share of Oils & Industries, Inc. was \$19.88,<sup>105</sup> so that Group Assets, Inc. received a premium of \$1.53 per share above the asset value of the stock, the total premium amounting to \$38,250.<sup>106</sup>

To finance the purchase, Home and Foreign Securities Corporation was required to liquidate a large portion of its portfolio of securities and to negotiate a bank loan of \$360,000.<sup>107</sup> Ultimately the shares of Oils & Industries, Inc. were the principal asset of Home and Foreign Securities Corporation.<sup>108</sup> The effect of the purchase

<sup>102</sup> Home and Foreign Securities Corporation had been organized and sponsored by Mr. Kleeman in 1929. The net capital contribution made to the corporation by its stockholders was \$2,872,000 of which \$750,000 represented the contribution of Mr. Kleeman. (Id., at 14818, 14797.) By June of 1934, the assets of Home and Foreign Securities Corporation totaled approximately \$352,000 (id., at 14819), including a loss realized and unrealized to its stockholders of approximately \$2,500,000. From 1929 to 1934, these large losses had been the result of specialization in bank stocks. (Id., at 14810-5.) Mr. Kleeman testified (id., at 14815):

Q. Well, let me ask you this general question: The experience of Home and Foreign in the course of its investments in banking situations was rather unfortunate?

A. I think that is an accurate description.

<sup>103</sup> Op. cit. supra, note 1, Commission's Exhibit No. 1442; op. cit. supra, note 82, at 14835, 14854.

<sup>104</sup> Op. cit. supra, note 82, at 14851, 14854.

<sup>105</sup> Id., at 14854.

<sup>106</sup> No active market for the Oils & Industries, Inc. stock existed. Home and Foreign Securities Corporation could only liquidate the stock at a loss by presenting it to Oils & Industries, Inc. for redemption at 95% of its liquidating value and, as will be described later, the privilege of redemption afforded to stockholders of Oils & Industries, Inc. was subsequently eliminated.

<sup>107</sup> Id., at 14836-7.

<sup>108</sup> Id., at 14834.

was to transform Home and Foreign Securities Corporation into a holding company of an investment company and subject its minority stockholders to a duplication of salaries for management. Home and Foreign Securities Corporation, which paid Mr. Kleeman annual compensation of \$6,000,<sup>109</sup> in essence had assets consisting only of its pro rata interest in the assets of Oils & Industries, Inc. On the other hand, Oils & Industries, Inc. paid Mr. Kleeman as at December 31, 1937, an annual salary of \$10,000. Mr. Kleeman testified:<sup>110</sup>

Q. So as is the case in every instance where one investment trust buys the securities of another investment trust, you have a double management salary, a double management fee, isn't that so?

A. You won't mind if I differ from your way of stating it?

Q. No.

A. I feel this way about it, since I devote 90% of my time in trying to rebuild these companies I am entitled to all I am getting from the two companies but the salary is divided in that way because we don't want to put too much burden on either one. That doesn't change the result in any way but it is a different theory.

Q. I know, but if Home and Foreign now took part of its diversified portfolio and changed it to Oils & Industries—

A. That is true.

Q. So that the compensation that you get in the form of a salary from Home and Foreign for managing Home and Foreign is for the entire fund, isn't that so? Now, part of the fund of securities from which you are getting compensation is from another source, isn't that so?

A. That is true.

Moreover, under the management of Mr. Kleeman the ratio of management salaries and other expenses to the net assets and ordinary income of Oils & Industries, Inc. had increased sharply. As at December 31, 1937, in contrast to the annual management fee amounting to one-half of 1% of its average monthly net assets formerly paid by Oils & Industries, Inc. to Petroleum Research Corporation, Mr. Kleeman's salary of \$10,000 was in excess of 1% of the investment company's then net assets of \$798,936.<sup>111</sup>

<sup>109</sup> Id., at 14867.

<sup>110</sup> Id., at 14867-8.

<sup>111</sup> As at December 31, 1937. Oils & Industries, Inc., had net assets of \$798,936 and total management and other expenses, including salaries, of \$96,000, equivalent approximately to 12% of net assets. As at September 30, 1931, prior to Mr. Kleeman's succession to the management of the company its net assets totaled approximately \$1,200,000, and its expenses, including management fees paid to Petroleum Research Corporation, were approximately \$36,000, or about 3% of net assets. As at December 31, 1932, the company had net assets of \$817,800 and total expenses of \$71,233, or approximately 9% of net assets. As at December 31, 1936, Oils & Industries, Inc., had net assets totaling \$1,424,000 and total expenses of \$90,000, or approximately 6% of net assets.

The ratio of total expenses of Oils & Industries, Inc., to its ordinary income other than capital gains during the period of the management of the company by Mr. Kleeman is indicated in the following table:

Period ending—	Total expense	Total ordinary income	Ratio of expense to ordinary income
Sept. 30, 1931.....	\$36,117	\$45,576	0.8 to 1
Under Management of Mr. Kleeman:			
Dec. 31, 1932.....	71,233	60,799	1.2 to 1
Dec. 31, 1936.....	90,301	71,622	1.3 to 1
Dec. 31, 1937.....	96,461	45,974	2.1 to 1

(Derived from supplementary information supplied the Commission for Oils & Industries, Inc., Annual Reports to Stockholders for periods ending Sept. 30, 1931, Dec. 31, 1932, Dec. 31, 1936, and Dec. 31, 1937.)



Although the purchase of the stock of Oils & Industries, Inc., constituted a substantial deviation from the previous activity of Home and Foreign Securities Corporation, which was the acquisition of bank stocks, nevertheless the minority stockholders were given no opportunity to be heard on the change in policy nor were the terms and purposes of the purchase revealed to them.<sup>112</sup>

# 1. RECAPITALIZATION OF OILS & INDUSTRIES, INC. TO ENABLE HOME AND FOREIGN SECURITIES CORPORATION TO FINANCE ITS PURCHASE OF CONTROL WITH THE FUNDS OF OILS & INDUSTRIES, INC.

Oils & Industries, Inc. redeemed 1,000 shares of the 25,000 shares of its common stock owned by Home and Foreign Securities Corporation, for \$20,000, 95% of their asset value,<sup>113</sup> which was applied by Home and Foreign Securities Corporation in reduction of its bank loan of \$360,000, incurred to purchase its holdings of the common stock of Oils & Industries, Inc. Further redemption of the remaining holdings of Home and Foreign Securities Corporation in the common stock of Oils & Industries, Inc.—24,000 shares or 43% of the voting stock—would have impaired its control of Oils & Industries, Inc.

As part of the entire plan to purchase the control from David Milton and his associates, Mr. Kleeman had determined to alter the capital structure of Oils & Industries, Inc. in a manner which would permit him, in effect, to utilize its assets to repay the \$360,000 bank loan incurred by Home and Foreign Securities Corporation. Briefly, the plan was to have the stockholders of Oils & Industries, Inc. authorize an issue of \$1 par value participating preferred stock entitled

<sup>112</sup> Mr. Kleeman conceded that the stockholders should have been informed of the contemplated change in the character of Home and Foreign Securities Corporation prior to its occurrence (op. cit. supra, note 82, at 14857-9) :

Q. Suppose a stockholder got the information you [Home and Foreign Securities Corporation] were substantially interested in bank stocks. He had stayed with this company [invested] in bank stocks during the period of terrific decline in bank stocks and he says "I will hold on until the bank stocks come back. Everything else is coming back, and I don't feel I will [want to] get out of this situation. I will stay with you." \* \* \* Then he gets a report a few months later which says he is no longer in a bank stock [investment company] but in a diversified portfolio?

A. That is correct.

Q. I am not saying that is unusual or that you were the only one [who did this], I am just arguing the general principle. [Even] if there was no disclosure [of policy] in the first instance, when the stockholder becomes apprised of the intended policy after the operations of the company commenced, there may be an element of reliance by the stockholder in continuing his investment in that situation, because over a period of time that was the policy of the company, isn't that so?

A. That is quite true.

Q. And then the next information he gets is that he is no more in an investment company specializing in bank stocks, he is now in an investment company which can be considered either one of two things, either a holding company for another investment trust or a diversified investment trust?

A. Yes, sir; and the only answer I have to that is we felt it was a move in the right direction.

Q. I am not disputing that, but don't we get down to the fundamental problem, [an] individual who may have been induced to invest in that situation due to the fact that throughout the history of the company it was investing in bank stocks is suddenly transformed into a [stockholder of] different type [of investment company] even though the management thought it was the best thing in the world?

A. \* \* \* we didn't have any avowal of purpose in the beginning and we didn't notify them of any change. I think in the light of what happened we would probably recite in great more detail what we were going to do and give notice of any change later. I think your point is well taken.

<sup>113</sup> Id., at 14852.

to a preference in assets of \$12.50 per share, on any dissolution of the investment company.<sup>114</sup> One share of the new preferred stock was to be issued as a stock dividend for each outstanding share of the investment company's common stock. This preferred stock was to be issued, although on July 28, 1933, after Mr. Kleeman had become associated with the company, all the outstanding units of preferred stock and common stock—the inseparable units which had been offered to the public—had been reclassified into shares of common stock, the original preferred stock thereby having been eliminated from the capital structure. In order to insure control in the common stock and to maintain the 43% voting power in Home and Foreign Securities Corporation, the new preferred stock was to have no voting rights.<sup>115</sup> The existing redemption right of the common stock was to be eliminated but the new preferred stock was to be redeemable at a price equivalent to 95% of the stock's liquidating value for a period of three weeks only and in lots of 1,000 shares only.<sup>116</sup> The 24,000 shares of new preferred stock to be issued to Home and Foreign Securities Corporation were to be redeemed under this provision. Thus, Home and Foreign Securities Corporation would acquire the funds to retire its bank loan. In addition, under the recapitalization plan Home and Foreign Securities Corporation would retain its working control of Oils & Industries, Inc. through its ownership of the common stock and prevent future diminution of the latter's assets as the result of redemptions.

Few, if any, of the stockholders of Oils & Industries, Inc. acquired lots of 1,000 shares of the new preferred stock as dividends. In fact, as will be shown, Home and Foreign Securities Corporation was the only one to exercise the limited redemption privilege accorded to the new preferred stock.

On August 31, 1934, approximately one and one-half months after Home and Foreign Securities Corporation acquired the stock of Oils & Industries, Inc., the stockholders of the investment company approved Mr. Kleeman's recapitalization plan. However, the letter<sup>117</sup> stating the purposes of the meeting omitted to inform the stockholders of the facts and circumstances under which Home and Foreign Securities Corporation had acquired control of their company or of the fact that it intended to redeem the new preferred stock to procure funds to repay the bank loan incurred in acquiring such control. In fact, any interest of Home and Foreign Securities Corporation in the preferred stock dividend was denied by implication, as disclosed in the following excerpt from that letter:<sup>118</sup>

Others, including the management who have recently acquired the largest single interest would perhaps prefer to acquire an increased interest in the common shares of the company carrying with them the benefit of any leverage created by the preference stock and insuring the continuity of their policies.

Immediately upon the change in the capitalization of Oils & Industries, Inc., it redeemed from Home and Foreign Securities Corporation the stock dividend of 24,000 shares of new preferred stock re-

<sup>114</sup> Op. cit. supra, note 1, Commission's Exhibit No. 1442, Item 7.

<sup>115</sup> Op. cit. supra, note 82, at 14848; op. cit. supra, note 1, Commission's Exhibit No. 1442, Item 7.

<sup>116</sup> Op. cit. supra, note 82, at 14843.

<sup>117</sup> Id., Commission's Exhibit No. 1519.

<sup>118</sup> Ibid.

ceived by Home and Foreign Securities Corporation. In redemption of this preferred stock Oils & Industries, Inc. transferred to Home and Foreign Securities Corporation portfolio securities having a market value of \$285,000.<sup>119</sup> These securities were then sold by Home and Foreign Securities Corporation and the proceeds applied to repay its bank loan. On the other hand, the minority stockholders of Oils & Industries, Inc. lost the benefit of the additional leverage which would have been afforded to their common stocks, had the assets of the investment company not been diminished by Home and Foreign Securities Corporation in redeeming its stock dividend.

Mr. Kleeman testified that the recapitalization plan was worked out as part of the plan for the purchase by Home and Foreign Securities Corporation of the block of stock of Oils & Industries, Inc. held by the Milton interests. Thus, as a result of the recapitalization plan, the Milton interests (which were not aware of the plan) were enabled, at least in part because of their contact with Oils & Industries, Inc. and their threat to merge it with The Equity Corporation, to sell their shares at a price in excess of their actual asset value, a price which could not have been obtained by presenting the shares to the company for redemption. Mr. Kleeman also conceded that the plan enabled Home and Foreign Securities Corporation to repay its bank loan through the sale of the securities received on the redemption of the preferred stock and to retain working control of Oils & Industries, Inc. through the retention of the common stock. Mr. Kleeman testified: <sup>120</sup>

A. \* \* \* The program of creating the new preferred stock of Oils & Industries, with a turn-in privilege, was worked out as part of the purchase, or as part of the whole plan, is that correct, Mr. Johnson [counsel for Oils & Industries, Inc.]?

Mr. JOHNSON. Part of the plan.

Q. Part of the plan?

A. It was not because it was part of the debt that they had to pay, it was all worked out as part of the plan.

Q. In any event you had the bank loan which had to be met.

A. That is right.

Q. Now you say, as part of the plan of the purchase of the stocks of the Milton interests, there was a further change in the capitalization of Oils & Industries.

A. That is correct.

Mr. Kleeman also testified: <sup>121</sup>

Q. \* \* \* What I said was that the ultimate effect of the transaction was that you used the funds of Oils & Industries, partially at least to enable Home and Foreign to acquire control of Oils & Industries.

A. I do not think that is correct.

Q. Well, you purchased the stock, and you did not have the money to do it, and so you made a loan.

A. That is right.

Q. Now, you had to pay that loan.

A. We had to pay that loan.

Q. Home and Foreign did not have the money to pay it.

A. That is correct.

Q. And if you did not get the money some place, the bank could foreclose on the loan?

A. That is right.

<sup>119</sup> Id., at 14846.

<sup>120</sup> Id., at 14837-8.

<sup>121</sup> Id., at 14847-50.

Q. So until you paid the loan, you did not really own the Oils & Industries stock? The bank owned the Oils & Industries stock.

A. \* \* \* we had the equity in it.

Q. You had the equity in it, but the way you eliminated the legal ownership of the bank and made your equity the legal ownership was to go to Oils & Industries, get \$285,000 for the preferred stock, and pay the loan.

A. Yes; but by turning in the preferred stock.

Q. There is no doubt about that. Then the effect of that was this, that you still held the common stock, is that not so?

A. That is right.

\* \* \* \* \*

Q. And when the preferred stock dividend was created the preferred stock had no vote, is that right?

A. That is right.

Q. So that the fact that you turned in the preferred stock did not in any wise diminish the voting power that Home and Foreign had.

A. That is correct.

\* \* \* \* \*

Q. It still retained control of the funds by virtue of its common stock ownership?

A. Yes; we did not have 51 percent, but in effect we had control.

As has been described, from 1928 to 1937 four different groups controlled the management of Oils & Industries, Inc. Yet the stockholders of the investment company were given no opportunity to be heard on the selection of these managers. The initial manager of the investment company, Pettigrew & Meyer, Inc., was unknown to the stockholders. The shift in control to Messrs. Watson, Herzberg, and Kahn occurred without the stockholders' immediate knowledge. The stockholders were not consulted prior to the selection of Mr. Kleeman and his associates as managers, nor were they consulted prior to the election of the appointees of David Milton and his associates to the directorate.<sup>122</sup> Although each of these groups profited directly or indirectly by the association with the investment company, by December 31, 1935 the stockholders of Oils & Industries, Inc. had suffered, out of a net investment in the company of approximately \$5,400,000, total realized and unrealized losses in excess of \$4,000,000.<sup>123</sup>

#### IV. CHATHAM PHENIX ALLIED CORPORATION (LATER KNOWN AS SECURITIES ALLIED CORPORATION)\*

##### A. Summary

Chatham Phenix Allied Corporation, organized on September 28, 1929, under the laws of Delaware, was sponsored by Chatham Phenix Corporation, the security affiliate of Chatham Phenix National Bank & Trust Company of New York.

The investment company issued \$2,000,000 shares of capital stock; 1,900,000 nonvoting shares were offered to the public at a gross price of \$27 per share, of which the investment company was to receive \$25 per share; and the remaining 100,000 shares, which had the sole voting power, were sold to the security affiliate at \$25 per share. Chatham Phenix Corporation therefore with an investment of \$2,500,000 acquired absolute control of the investment company with total assets of \$50,000,000. The security affiliate obtained approximately \$2,245,000

<sup>122</sup> Id., at 14864 5.

<sup>123</sup> As at December 31, 1935, the net assets of the investment company totaled \$928,000, as compared with a net investment by the stockholders of \$5,400,000, as of December 31, 1935, after giving effect to repurchases by the investment company of \$6,250,000 of its own securities and the payment of dividends of \$1,600,000. (Op. cit. supra, note 1, Commission's Exhibit No. 1437.)

\*Commissioner Frank did not participate in the consideration of this account of Chatham Phenix Allied Corporation.

in selling commissions and trading profits incident to the public offering of the nonvoting shares, which was only \$255,000 less than the cost to it of the 100,000 voting shares.

The security affiliate, which headed the selling syndicate, agreed to pay for the 2 000,000 shares at \$25 a share on October 8, 1929. On this date the security affiliate delivered its check on Chatham Phenix National Bank & Trust Company for \$50,000 000 in payment therefor. However, on October 9, 1929, when the check was presented for payment, the drawer, the security affiliate, had only \$32,000,000 on deposit with the bank. The bank, however, honored the check, presumably because of the common management of the bank, of the security affiliate and of the investment company. In effect, the bank allowed an overdraft of \$18,000,000 in favor of the security affiliate. To meet the overdraft, the security affiliate then borrowed \$18,000 000 from Chatham Phenix Allied Corporation—the investment company which the security affiliate had sponsored and whose securities it had agreed to purchase for cash. The loan remained open and was not paid in full until 1931 when the investment company was sold to Atlas Corporation. In various prospectuses and applications for listings on stock exchanges, the investment company stated it had received payment in full of \$50 000,000 in cash for its shares.

During the period of management of the investment company by the security affiliate of the bank, the investment company's funds were used to trade in the stock of the bank in the declining market after October 1929.

The investment company sustained losses of \$5,800,000 in transactions in which almost all of the directors of the investment company were pecuniarily interested and sustained losses of \$3,200,000 in investments in companies of which directors of the investment company were also directors. The depreciation, as at December 31, 1930, in investments made in companies having some association or connection with the sponsor, or the officers or directors of the investment company, was 61%. This shrinkage may be compared with a figure of less than 30% constituting the decline in investments made in companies having no such connection.

The largest single loss sustained by the investment company, \$5,410,930, arose from a purchase of debentures of Empire State, Inc., costing \$6,075,000. This investment was made after a prior investment of \$5,000,000 had been made by a syndicate of which the sponsor was the manager and which consisted of twelve of the bank's directors (eleven of whom were directors of the investment company) to build the Empire State Building in New York City.

When the performance and activities of the investment company began to react against the reputation of the bank in 1931, the security affiliate, which had represented that it would hold the voting stock of the investment company as a permanent investment, sold such stock together with a large block of the investment company's nonvoting stock to Atlas Corporation for more than \$8,000,000, a price which exceeded both the market and asset value of the stock. Notice of the sale of control of the investment company was not given to its stockholders until after its consummation.

Atlas Corporation borrowed the \$8,000,000 it needed to make this purchase and these funds enabled the security affiliate to repay its indebtedness to the investment company. But simultaneously, Atlas Corporation, with the knowledge and consent of the security affiliate but without the knowledge of the investment company's stockholders, sold to the investment company for \$8,000,000 large blocks of the securities of other investment companies. With the proceeds of these sales Atlas Corporation repaid the loans it had made to obtain the funds necessary to purchase control of the investment company from the security affiliate.

On the date that Atlas Corporation had acquired control, the investment company had assets of approximately \$31,000,000 consisting of cash and diversified securities. As a result of the shift in control, the investment company had placed a substantial portion of its assets in the securities of other investment companies. By December 8, 1933, when the investment company was dissolved, approximately \$27,000,000 of its funds were invested in the securities of other investment companies controlled by Atlas Corporation.

## B. Organization

Chatham Phenix Allied Corporation was incorporated under the laws of Delaware on September 28, 1929,<sup>1</sup> under the sponsorship of

<sup>1</sup> Public Examination, Chatham Phenix Allied Corporation, Commission's Exhibit No. 1588.

Chatham Phenix Corporation, the security affiliate of Chatham Phenix National Bank & Trust Company of New York City.<sup>2</sup> The security affiliate was engaged primarily in the investment banking business, buying and selling securities and the other usual activities of bank security affiliates.<sup>3</sup>

As was the general practice prior to the enactment of the Banking Act of 1933, which divorced national banks from their security affiliates, the stock of Chatham Phenix Corporation, the security affiliate, was physically attached to the stock of the bank and was not transferable except with the bank stock. The stock of the security affiliate was held in a voting trust of which the trustees were Louis G. Kaufman, president and a director of the bank; Samuel McRoberts, chairman of the board of directors of the bank; Ellis P. Earle, Haley Fiske, and Richard H. Higgins,<sup>4</sup> directors of the bank.<sup>5</sup>

The bank and the security affiliate controlled the investment company, Chatham Phenix Allied Corporation, because the security affiliate acquired all the voting stock of the investment company and all the directors of the investment company were officers or directors of the bank,<sup>6</sup> with Samuel McRoberts, president of the investment company.<sup>7</sup>

Samuel McRoberts testified that this identity of management of the bank, the security affiliate, and the investment company was intentional,<sup>8</sup> and was strongly emphasized in the literature offering the stock of Chatham Phenix Allied Corporation to the public.<sup>9</sup> Mr. McRoberts stated that "it was the strength of the offering that the group had that control."<sup>10</sup>

Several reasons evidently motivated the organization of the investment company. Its avowed purpose was to operate as a general investment company. The prospectus stated:<sup>11</sup>

<sup>2</sup> Id., at 15424.

<sup>3</sup> Id., at 15420-1.

<sup>4</sup> Id., at 15419.

<sup>5</sup> *Moody's Manual of Investments, Banks, etc.*, 1929 p. 254.

<sup>6</sup> Op. cit. *supra*, note 1, at 15425.

<sup>7</sup> The following table illustrates the interlocking directorates of the bank, the security affiliate, and the investment company (id., Commission's Exhibit No. 1589 and *Moody's Manual of Investments, Banks, etc.*, 1930, pp. 164, 165, 2250):

<i>Bank</i> (32 directors)	<i>Security affiliate</i> (9 directors)	<i>Investment company</i> (16 directors)
1. Samuel McRoberts.	Samuel McRoberts.	Samuel McRoberts.
2. (*).	Rollin C. Bortle.	Rollin C. Bortle.
3. William B. Joyce.	William B. Joyce.	William B. Joyce.
4. Richard H. Higgins.	Richard H. Higgins.	Richard H. Higgins.
5. Louis G. Kaufman.	Louis G. Kaufman.	Louis G. Kaufman.
6. Ellis P. Earle.	Ellis P. Earle.	Ellis P. Earle.
7. J. Frederick Talcott.	J. Frederick Talcott.	J. Frederick Talcott.
8. S. B. Thorne.	S. B. Thorne.	S. B. Thorne.
9. Edgar S. Bloom.	Edgar S. Bloom.	Edgar S. Bloom.
10. Harold I. Pratt.		Harold I. Pratt.
11. Edward F. Hutton.		Edward F. Hutton.
12. Frank Phillips.		Frank Phillips.
13. George MacDonald.		George MacDonald.
14. Eugene E. du Pont.		Eugene E. du Pont.
15. Fred M. Kirby.		Fred M. Kirby.
16. Van Lear Black (and 17 others).		Van Lear Black.

\*Rollin C. Bortle, although not a director of the bank, was a vice president.

<sup>8</sup> Op. cit. *supra*, note 1, at 15425.

<sup>9</sup> Id., Commission's Exhibit No. 1589 and the reply to the Commission's questionnaire for Securities Allied Corporation, pt. I (Exhibit 9).

<sup>10</sup> Op. cit. *supra*, note 1, at 15429.

<sup>11</sup> Reply to the Commission's questionnaire for Securities Allied Corporation, Pt. I (Exhibit 9).

Chatham Phenix Allied Corporation, to be organized under the laws of Delaware, will be empowered by its charter to buy, sell, and trade in equities, stocks, and securities of any kind, to participate in underwritings and syndicates, and to engage in such other investment activities as its Board of Directors may determine.

It appears, however, that the promoters created the investment company to raise a large fund to be used to reorganize enterprises which, it was believed, would shortly require financial rehabilitation.

With reference to the reasons for organizing the company,<sup>12</sup> Mr. McRoberts testified:<sup>13</sup>

Q. What did you visualize the nature of the business of the Allied Corporation to be? That is, at the time that you discussed its organization.

A. Well, there seemed—or a forecast of the future would seem to indicate that there was some need of some large units of capital to be used in the reorganization of the companies. That was on the theory that we were confronted with a reaction in the security market, and probably quite a severe one, from general finances of the industrial situation of the country.

If that forecast had been correct as to the extent of it, there would have been many industrial institutions that would need reorganization. That would require large units of capital to do it successfully. That was the expectation that led me to approve the formation of the company.

Q. Of course, this was in September of 1929, when it was ultimately organized, and there weren't any substantial rumblings with respect to any stock market crash, were there, at that time?

A. No.

Q. As I recall it, business conditions were still good?

A. Underlying: no.

Q. But you believed that superficially they were good but fundamentally they weren't?

A. The speculative spirit was running very high.

Q. And I suppose with that feeling that fundamentally the business condition of the country was unsound although its accurate condition was not shown by the ticker tape of the New York Stock Exchange, you say that \* \* \* the Allied Corporation was formed to anticipate the possible recognition of the fundamental unsoundness of business?

A. Well, to take care of a situation that at least I thought was fairly sure to occur.

That the promoters anticipated a marked business depression and that the funds of the investment company would be used to reorganize failing industrial institutions was not disclosed in any prospectus nor referred to in any selling campaign.

On September 30, 1929, the sponsor agreed to purchase all the voting stock of the investment company, 100,000 shares, and 1,900,000 shares of nonvoting stock of the authorized 3,000,000 shares of capital stock of Chatham Phenix Allied Corporation at a price of \$25 per share, to net the corporation \$50,000,000.<sup>14</sup> Delivery and payment for the shares were to be concurrently made on October 8, 1929.<sup>15</sup> The prospectus offering the nonvoting stock set forth that Chatham Phenix Corporation was to acquire all of the voting stock as an "investment."<sup>16</sup> Thus with an investment of \$2,500,000, the

<sup>12</sup> A letter dated September 20, 1929, to the stockholders of the bank, signed by Rollin C. Bortle as president of the security affiliate, the sponsor, soliciting the purchase of the stock of the investment company, stated (i)dd.): "The organization of the corporation will afford the means of participation in financial activities which are beyond the ordinary activities of the Chatham Phenix National Bank & Trust Company or of its affiliate, Chatham Phenix Corporation."

<sup>13</sup> Op. cit. supra, note 1, at 15422-3.

<sup>14</sup> Id., at 15426-7.

<sup>15</sup> Id., at 15433 and Commission's Exhibit No. 1590.

<sup>16</sup> Id., Commission's Exhibit No. 1589.



Chatham Phenix Corporation acquired sole and absolute control of the investment company with total assets of \$50,000,000. In fact, since Chatham Phenix Corporation derived approximately \$2,245,000<sup>17</sup> in selling commissions and trading profits incident to the public offering of the nonvoting shares, the cost to this affiliate for the 100,000 shares of voting stock was only \$255,000 more than the profit it derived from the offering.

The representation that the sponsor would purchase the control and hold it for permanent investment was the "strength of the offering." Mr. McRoberts testified:<sup>18</sup>

A. It was the strength of the offering that the group had that control. That is what made the stock so well received by the public.

Q. It was the feeling of confidence that a stockholder would have that his corporation was being controlled by the officers and directors of the bank, and was directly owned by a security affiliate of the bank, which was being supervised by banking officials and banking authorities, and he could give a sigh of relief that that stock was not in strange, incompetent hands, is that correct?

A. That is correct.

However, as will be seen, the sponsor sold control to Atlas Corporation in August of 1931, less than two years later, without previously informing the stockholders of Chatham Phenix Allied Corporation of the proposed transfer.<sup>19</sup>

### C. Public Offering of Shares of Chatham Phenix Allied Corporation

Late in September of 1929, the security affiliate and a selling group of dealers offered to the public at a price of \$27 per share the 1,900,000 shares of the nonvoting stock. The gross selling commission to the security affiliate was \$2 per share. After payment of selling group commissions and after including profits made by the security affiliate from trading in the stock of the investment company, its profit was \$2,245,000.<sup>20</sup>

On October 8, 1929, the date on which Chatham Phenix Allied Corporation was to receive \$50,000,000 from the security affiliate, its sponsor, in payment for the 100,000 shares of its voting stock and for the \$1,900,000 shares of its nonvoting stock, the security affiliate actually had on deposit<sup>21</sup> with Chatham Phenix National Bank & Trust Company only \$3,892,995. Nevertheless, on October 8, 1929, the security affiliate delivered to the investment company a check in the sum of \$50,000,000 drawn on Chatham Phenix National Bank & Trust Company to the order of the investment company.<sup>22</sup> On October 9, 1929, when the check was presented for payment, the cash balance of the security affiliate at the bank was only \$32,341,600.<sup>23</sup> However, on that date the bank honored the check.

<sup>17</sup> Id., at 15564.

<sup>18</sup> Id., at 15429.

<sup>19</sup> Id., at 15430 and Commission's Exhibit No. 1617.

<sup>20</sup> Id., at 15562-4. The trading profits were apparently derived from purchases and sales during the distribution of the Chatham Phenix Allied Corporation stock to the public by the selling group. (Ibid.)

<sup>21</sup> Id., Commission's Exhibit No. 1593.

<sup>22</sup> Id., Commission's Exhibit No. 1592.

<sup>23</sup> Id., at 15556, 15437-8 and Commission's Exhibit No. 1593.



Although Mr. McRoberts, president of Chatham Phenix Allied Corporation, insisted that the public offering of the nonvoting shares had been successful,<sup>24</sup> he admitted that there had been a delay by the selling group in taking down and paying its subscriptions for the stock.<sup>25</sup>

In order to clear the check in the amount of \$50,000,000, the investment company on October 9, 1929 authorized the bank to debit the investment company's account in the sum of \$18,000,000 and to credit the security affiliate's account in that amount.<sup>26</sup>

As to this transaction, Mr. McRoberts stated:<sup>27</sup>

\* \* \* I didn't know until long afterwards that there was any discrepancy in the affiliate's account with the bank when they issued the \$50,000,000 check, and I did learn it afterwards but at the time nothing was said to me about it, but they came to us, and asked us to loan them \$18,000,000 against these unpaid subscriptions, and well, we had no hesitation in doing it because there was a very powerful syndicate back of those subscriptions, and they had to be paid.

The loan was evidenced by a debit slip signed by the treasurer of the security affiliate.<sup>28</sup>

Despite Mr. McRoberts' assertion that the honoring of the \$50,000,000 check drawn by the security affiliate against insufficient funds constituted a payment in cash,<sup>29</sup> it is obvious that as a result of these transactions in which the bank participated, Chatham Phenix Allied Corporation received for its stock, instead of \$50,000,000 in cash, only \$32,000,000 in cash and the initially unsecured promise of the security affiliate to pay the additional \$18,000,000. For almost two years a substantial proportion of the funds of the investment company was involved in this loan to its sponsor, the security affiliate, and the indebtedness was only completely repaid on August 17, 1931, when the security affiliate transferred control of the investment company to Atlas Corporation. Apparently the security affiliate was only able to obtain sufficient funds to repay its indebtedness to the investment company (then amounting to over \$10,000,000) by selling to Atlas Corporation the 100,000 shares of voting stock of the investment company, together with a large block of nonvoting stock of the investment company that it held.<sup>30</sup>

Mr. McRoberts, who was the president of the investment company, chairman of the board of directors of the bank and director of the security affiliate, and who received the check for \$50,000,000 on behalf of the investment company, testified that he did not know whether the maker of the check, the sponsor, had \$50,000,000 on deposit on October 8, 1929,<sup>31</sup> but recalled only that the check was delivered to him

<sup>24</sup> *Id.*, at 15555.

<sup>25</sup> *Id.*, at 15440. Apparently a considerable block of Chatham Phenix Allied Corporation stock was never finally placed by the security affiliate with the public. As at November 14, 1929, the minutes of a meeting of the board of directors of Chatham Phenix Corporation indicate that it was carrying 463,352 shares of Chatham Phenix Allied Corporation stock. (*Id.*, at 15559.) As at August 17, 1931, when the security affiliate transferred control of the investment company to Atlas Corporation, it held 418,368 shares of the investment company stock. (See also note 141, *infra*.)

<sup>26</sup> *Id.*, at 15445-7 and Commission's Exhibits Nos. 1592, 1593, 1595.

<sup>27</sup> *Id.*, at 15445.

<sup>28</sup> *Id.*, at 15445-55 and Commission's Exhibit No. 1595.

<sup>29</sup> *Id.*, at 15448.

<sup>30</sup> The manner of this repayment and the transfer of control will be discussed later.

<sup>31</sup> *Op. cit. supra*, note 1, at 15435 and 15556.

and that he ordered the stock issued.<sup>32</sup> Mr. McRoberts admitted, however, that the records showed that the sponsor did not have the \$50,000,000 in cash with which to meet its commitment:<sup>33</sup>

Q. The security affiliate which was closely tied up with the bank, being the same stockholders, on October 8th, when it had to meet its commitment of \$50,000,000, did not have \$50,000,000 in cash.

A. It would seem to indicate it from those records.

\* \* \* \* \*

Q. Well, the fact is, General, that without this debit slip, Commission's Exhibit 1595, which enabled the bank to put a credit on the account of the security affiliate, there wouldn't have been the \$50,000,000 there to meet the check.

A. They would have been overdrawn.

That a disclosure to the public of the failure of the security affiliate to raise the \$50,000,000 in cash on the date of payment to Chatham Phenix Allied Corporation might have had an adverse effect upon the prestige and reputation of the bank, Chatham Phenix National Bank & Trust Company, was conceded by Mr. McRoberts:<sup>34</sup>

Q. \* \* \* If I may go back to the origination of the Allied Corporation, it was quite essential, was it not, that as far as the bank was concerned that the impression should not go out among the public that the issue of securities of the Allied Corporation was not being successfully floated, otherwise it might redound to the damage of the bank; isn't that so?

A. Well, it never arose, because it was very successful.

Q. I was talking hypothetically.

A. If it had failed, you mean?

Q. If the issue was a failure, of course, that would reflect on the bank; isn't that so?

A. Possibly; to some extent, I mean.

Q. Because here they were sponsoring an investment trust, and if you would not sell the securities immediately, people would say, "Well, there must be some difficulty \* \* \* with the bank, because people have no confidence in them and will not buy." \* \* \* isn't that so?

A. Yes; that is true, but we took precautions on that.

Q. But you did tell us that in October when payments were due on these various subscriptions that there was a lot of confusion, and that the \$50,000,000 on these subscriptions was not physically present in the security affiliate [Chatham Phenix Corporation] on October 9; isn't that so?

A. That is true; some of the subscriptions had not been paid.

Mr. McRoberts, when examined as to whether the loan was not made to meet certain requirements of the Delaware law under which the company was incorporated, testified:<sup>35</sup>

Q. Now, of course, it would make a very substantial difference, would it not, General—you are a lawyer—whether there was \$50,000,000 of cash paid for this stock rather than \$32,000,000 of cash, and \$18,000,000 being in the form of an obligation; isn't that so?

A. But I don't think that is so, or was so, in that situation.

Q. I am just talking abstractly.

A. Certainly, it would make a difference of \$18,000,000.

Q. And it would make a difference in the legal effect—in the legal consequences, because under the Delaware law you could not issue stock on credit.

A. I didn't issue it until we had a credit in the bank of \$50,000,000.

Q. Also, if the stock was not issued for cash, but was issued for credit, you could not pay dividends on the stock which was issued for credit under the Delaware law; you know that.

A. Yes; certainly.

<sup>32</sup> Id., at 15436.

<sup>33</sup> Id., at 15446-7.

<sup>34</sup> Id., at 15554-6.

<sup>35</sup> Id., at 15556-7.

Q. So that it was essential that the transaction be such that the stock be issued for cash on October 9th; isn't that so?

A. Yes, sir; that is right.

Q. And you say that it wasn't deliberately done to give you a credit of \$50,000,000 and an \$18,000,000 loan made right back?

A. No, sir.

Q. You say that those two transactions were separate and independent? Is that right?

A. That is right.

No collateral was initially given by the sponsor for this loan of \$18,000,000. Mr. McRoberts testified that because it was expected that the loan would run only a few days and he had absolute confidence in the officers of the sponsor, no collateral was required.<sup>36</sup> However, practically an open account existed between the sponsor and the investment company during the entire period of almost two years that the sponsor remained in control,<sup>37</sup> and the indebtedness of the sponsor to the investment company always exceeded \$7,000,000<sup>38</sup> until finally paid in August 1931.

The first entry in the loan account was the \$18,000,000 occasioned by the loan granted the sponsor on October 9, 1929,<sup>39</sup> in connection with the underwriting of the investment company shares. By October 14, 1929, the security affiliate had repaid \$11,000,000 of its indebtedness to Chatham Phenix Allied Corporation, leaving a balance due of \$7,000,000.<sup>40</sup> Thereafter, the security affiliate made additional loans from the investment company which were collateralized.<sup>41</sup> On December 31, 1929,<sup>42</sup> the security affiliate owed Chatham Phenix Allied Corporation \$15,700,000; on December 31, 1930,<sup>43</sup> \$10,500,000; and on August 17, 1931,<sup>44</sup> \$10,556,994. From September 1929 to August 1931, when Atlas Corporation acquired control of the investment company, an average of \$10,000,000 or 20% of the assets of Chatham Phenix Allied Corporation was continuously on loan to the sponsor, Chatham Phenix Corporation.

## 1. REPRESENTATIONS IN CONNECTION WITH PUBLIC OFFERING

In all the advertising material and in the listing applications the representation was made that all the stock of the investment company had been issued for \$50,000,000 in cash.<sup>45</sup> In seeking listing with the Boston Stock Exchange, the investment company represented:<sup>46</sup>

The Corporation has received payment in full for its shares at the rate of \$25 per share net in cash, such payment having been made on or about October 8, 1929.

<sup>36</sup> Id., at 15455.

<sup>37</sup> Id., at 15456-61 and Commission's Exhibit No. 1596.

<sup>38</sup> Id., at 15457-9.

<sup>39</sup> Id., Commission's Exhibits Nos. 1594-1595.

<sup>40</sup> Id., Commission's Exhibit No. 1596.

<sup>41</sup> Ibid.

<sup>42</sup> Ibid.

<sup>43</sup> Ibid.

<sup>44</sup> Ibid.

<sup>45</sup> Id., at 15556.

<sup>46</sup> Id., Commission's Exhibit No. 1611.

In a letter dated December 4, 1929, sent by the sponsor recommending purchase of the investment company stock, it was stated:<sup>47</sup>

Chatham Phenix Allied Corporation received on October 8, 1929, \$50,000,000 in cash from the sale of 2,000,000 shares of common stock.

\* \* \* \* \*

This Corporation was in the advantageous position of having \$50,000,000 in cash, all of which was available when the serious decline in the Market began, and as of November 30, 1929, the Corporation was in the fortunate position of having \$36,615,725 in cash, call or time loans, which is over 72% of its total assets, and amounted to \$18.30 per share on the Common Stock outstanding. The balance of its assets has been invested mainly in listed and readily marketable dividend-paying common stocks of the leading Railroad, Public Utility, and Industrial companies.

The Board of Directors, all the members of which are also directors of the Chatham Phenix National Bank and Trust Company, consists of men of prominence and outstanding ability.

As a matter of fact, on December 4, 1929, among the loans referred to above was the loan to the sponsor which then amounted to \$15,500,000;<sup>48</sup> and among the securities owned were 13,870 shares of Chatham Phenix National Bank & Trust Company purchased at a net cost of \$1,690,806.20<sup>49</sup> in a declining market<sup>50</sup> after October 25, 1929.

## D. Management Activities

### 1. PORTFOLIO INVESTMENTS

The investment company eventually suffered severe losses<sup>51</sup> on investments which were made during the period of its control by the security affiliate. Approximately \$5,800,000 was lost in transactions in which the sponsor and directors had directly or indirectly a substantial pecuniary interest. In addition, losses of approximately \$3,200,000 were suffered by the investment company on investments in companies of which its officers or directors were also directors.

### 2. INVESTMENT IN EMPIRE STATE, INC.

The largest single loss of the investment company was sustained in connection with the financing of the erection of the Empire State Building in New York City by Empire State, Inc. The investment company had purchased \$6,750,000 face amount of debentures of Empire State, Inc., at a cost of \$6,075,000, on which it ultimately suffered a loss of \$5,410,930. This investment was directly attributable to the relationship of the investment company with Chatham Phenix National Bank & Trust Company and its security affiliate, Chatham Phenix Corporation.

Prior to the organization of the investment company, Bethlehem Engineering Corporation, a corporation controlled by one Floyd Brown and one George Coughlan, entered into a contract on November 21, 1928, to acquire the site of the old Waldorf Astoria Hotel at 34th Street and Fifth Avenue in the city of New York,<sup>52</sup> with the

<sup>47</sup> Op. cit. supra, note 11, Pt. I (Exhibit 10).

<sup>48</sup> Op. cit. supra, note 1, Commission's Exhibit No. 1596.

<sup>49</sup> Id., Commission's Exhibit No. 1618 (Schedule 3).

<sup>50</sup> See discussion, infra, p. 131.

<sup>51</sup> Op. cit. supra, note 1, Commission's Exhibit No. 1618.

<sup>52</sup> Id., at 15468-71 and Commission's Exhibit No. 1598.

purpose of erecting upon the site the largest office building in the world. The contract purchase price for the site was \$3,000,000, payable \$1,500,000 prior to May 1, 1929, and \$1,500,000 prior to June 1, 1929.<sup>53</sup> In February 1929 Chatham Phenix National Bank & Trust Company advanced to Bethlehem Engineering Corporation \$1,500,000<sup>54</sup> to enable that corporation to make the initial payment on its purchase contract. Bethlehem Engineering Corporation thereafter applied to the Metropolitan Life Insurance Company for a loan of \$24,000,000 to erect the building, to be secured by a first mortgage upon the property.<sup>55</sup>

Early in May of 1929 Chatham Phenix National Bank & Trust Company demanded payment of its \$1,500,000 loan to the Bethlehem Engineering Corporation;<sup>56</sup> but Messrs. Brown and Coughlan, who controlled the Bethlehem Engineering Corporation, resisted the demand on the ground that their arrangement with the bank was in reality a joint venture to erect an office building on the Waldorf Astoria site—the bank to finance the project and Bethlehem Engineering Corporation to contribute its engineering and real estate development skill.<sup>57</sup>

Although Samuel McRoberts, then the chairman of the board of directors of the Chatham Phenix National Bank & Trust Company, characterized these claims of Brown and Coughlan as “wild,”<sup>58</sup> he admitted that had a law suit been instituted by the bank to enforce payment of the loan, the public disclosure of an action connecting the bank with this particular real estate venture involving millions of dollars would react unfavorably upon the bank’s reputation.<sup>59</sup> Mr. McRoberts testified that to avoid this consequence and also because they felt it to be a good investment, several of the directors of Chatham Phenix National Bank & Trust Company determined to form a syndicate to acquire the contract rights of Bethlehem Engineering Corporation to purchase the real property and to proceed with its application with the Metropolitan Life Insurance Company for a loan of \$24,000,000.<sup>60</sup>

On May 22, 1929, the Waldorf Astoria Building Syndicate<sup>61</sup> was formally organized with the security affiliate, Chatham Phenix Corporation, as the syndicate manager. The members of the syndicate, all of whom were directors of the bank, agreed to become liable to

<sup>53</sup> Id., Commission’s Exhibit No. 1598, p. 2.

<sup>54</sup> Id., at 15475 and Commission’s Exhibit No. 1598 (Schedule A, Item 3).

<sup>55</sup> Id., Commission’s Exhibit No. 1598 (Schedule A, Commitment 2). This particular application for a mortgage was never granted by the insurance company. A subsequent application by the succeeding interests for \$27,500,000 was granted. (See *infra*.)

<sup>56</sup> Op. cit. *supra*, note 1, at 15476.

<sup>57</sup> On this claim Mr. McRoberts testified as follows (*id.*, at 15478–9) :

Q. Will you give us as much detail as you can of what transpired at that time, and what was the friction that existed?

A. Well, they claimed an understanding to the effect that the bank was a partner with them.

Q. That is, by “them” you mean Brown and Coughlan claimed that when you tried to enforce collection of the loan, that this was a joint venture between Bethlehem Engineering Corporation and the bank, and it was never contemplated that they would be obligated to pay that loan?

A. Something to that effect.

<sup>58</sup> Op. cit. *supra*, note 1, at 15479.

<sup>59</sup> Id., at 15480.

<sup>60</sup> Id., at 15480–1.

<sup>61</sup> Id., Commission’s Exhibit No. 1598.

the syndicate in the total sum of \$5,100,000<sup>62</sup> in the following amounts:<sup>63</sup>

L. G. Kaufman-----	\$2,000,000	S. B. Thorne-----	\$100,000
Samuel McRoberts-----	500,000	J. F. Talcott-----	100,000
Frank Phillips-----	500,000	Edgar S. Bloom-----	100,000
E. P. Earle-----	500,000	Max S. Weil-----	150,000
E. F. Hutton-----	500,000	Richard H. Higgins-----	50,000
F. M. Kirby-----	500,000	Wm. B. Joyce-----	100,000

The syndicate raised this \$5,100,000 by borrowing \$2,700,000 from the Chatham Phenix National Bank & Trust Company and \$2,400,000 from the security affiliate.<sup>64</sup> With part of these borrowed moneys, the syndicate acquired the contract of Bethlehem Engineering Corporation to purchase the Waldorf Astoria site and an assignment of the application of Bethlehem Engineering Corporation for the \$24,000,000 mortgage loan from the Metropolitan Life Insurance Company.<sup>65</sup> The consideration received by Bethlehem Engineering Corporation for these assignments was the payment by the syndicate of the "debt" of Bethlehem Engineering Corporation in the sum of \$1,500,000 to the Chatham Phenix National Bank & Trust Company. In this manner the "loan" of the bank to Bethlehem Engineering Corporation was repaid, and the security affiliate and bank became involved in the Empire State building project.

The syndicate agreement contemplated the formation of a corporation to take over the contract to purchase the Waldorf Astoria site and to construct the building.<sup>66</sup> On April 30, 1929, a corporation known as Enyan Corporation<sup>67</sup> was formed by the syndicate for this purpose. In June of 1929, the name of this corporation, after several changes, became Empire State, Inc.<sup>68</sup> One-half of the capital stock of the Empire State, Inc. was issued to the syndicate in consideration of the transfer to the corporation by the syndicate of the contract to acquire the site (the contract was valued at \$2,500,000, the amount of the payments which had by then been made under it) and \$2,500,000 in cash.<sup>69</sup> The Empire State, Inc. stock received by the syndicate was deposited with the security affiliate as collateral for the loans aggregating \$5,100,000 which were made to the syndicate by the security affiliate and Chatham Phenix National Bank & Trust Company.<sup>70</sup> This collateral was to secure the bank and the security affiliate jointly, and the proceeds thereof were to be shared by the lenders in the event of default on the loans in the ratio that each loan bore to the total loan.<sup>71</sup>

The remaining half of the stock of Empire State, Inc., was purchased for the sum of \$5,000,000 by Pierre S. du Pont and John J. Raskob, whom Louis G. Kaufman, the chairman of the board of

<sup>62</sup> Id., at 15482.

<sup>63</sup> Id., at 15483-4.

<sup>64</sup> Id., at 15486-7.

<sup>65</sup> Id., Commission's Exhibit No. 1598 (Schedule A, Commitment 2).

<sup>66</sup> Id., Commission's Exhibit No. 1598 (p. 3).

<sup>67</sup> Id., Commission's Exhibit No. 1597.

<sup>68</sup> Id., at 15485.

<sup>69</sup> Id., at 15493-4, 15502.

<sup>70</sup> Id., at 15540 and Commission's Exhibit No. 1608.

<sup>71</sup> Id., Commission's Exhibit No. 1608.

directors of Chatham Phenix National Bank & Trust Company and one of the syndicate members, had interested in the venture.<sup>72</sup>

The plans and specifications prepared by Empire State, Inc., for the office building to be erected on the Waldorf Astoria site contemplated the erection of an 85-story edifice, at a cost of approximately \$51,000,000.<sup>73</sup> To meet this estimated cost, Empire State, Inc. had, as has been indicated, received cash and other assets valued at a total of \$10,000,000 as consideration for the issuance of its capital stock. In addition, Empire State, Inc., in the latter part of 1929, had obtained a loan of \$27,500,000 from the Metropolitan Life Insurance Company.<sup>74</sup> This loan was secured by a first mortgage upon the land and the projected building. It was contemplated that the remainder of the funds necessary to complete the building would be raised by Empire State, Inc. through a public sale of second mortgage bonds.<sup>75</sup>

The foregoing account indicates the situation of the Empire State building venture on September 28, 1929, when the investment company, Chatham Phenix Allied Corporation, was created.

Approximately \$12,000,000 was required by Empire State, Inc. to complete the construction of the building.<sup>76</sup> It proposed to raise these funds by an issue of \$13,500,000 face amount of debentures secured by a second mortgage on the building. The debentures were to be sold at a 10% discount to the purchasers and were to be accompanied by a bonus of common stock. That the raising of the additional funds was imperative is indicated by the following testimony by Louis G. Kaufman, former president of the Chatham Phenix National Bank & Trust Company:<sup>77</sup>

Q. \* \* \* Now, if the second-mortgage money could not be raised, then, of course, the investment of the officers and directors of the syndicate was jeopardized, isn't that so?

A. That is true if the money could not have been raised, but perhaps it could have been raised on a building proposition of a much smaller scale.

Q. But if the original plans were adhered to and the building to cost approximately \$50,000,000 was to be erected, you had to raise at least \$12,000,000 additional or else you couldn't go through with your project?

A. We thought it desirable to raise it to cover any contingency or emergency that might arise, that senior to the \$10,000,000 the participants put in the proposition. In other words, the ten million, if I may explain it, that our associates put in the proposition was naturally subordinate to the second-mortgage bonds.

Q. I understand that, and yet if you didn't get the twelve million senior money, the ten million that had been put in might have been jeopardized; isn't that so?

A. If we couldn't have raised it. That is always a possibility in every business risk.

Mr. Kaufman conceded that a public offering of Empire State, Inc. debentures at that time would probably have been unsuccessful.<sup>78</sup> In this situation, the syndicate members and Messrs. Raskob and du Pont were faced with the alternatives of abandoning the venture with a possible loss to them of \$10,000,000, or of erecting a smaller building and thereby depriving the venture of the uniqueness of size which was

<sup>72</sup> Id., at 15490-1. Messrs. Kaufman, Raskob, and du Pont were fellow directors of General Motors Corporation. (Id., at 15472.)

<sup>73</sup> Id., Commission's Exhibit No. 1599.

<sup>74</sup> Id., at 15492 and Commission's Exhibit No. 1603 (p. 2).

<sup>75</sup> Id., at 15491, 15494.

<sup>76</sup> Id., Commission's Exhibit No. 1600.

<sup>77</sup> Id., at 15503.

<sup>78</sup> Id., at 15504.



considered commercially attractive, or of personally advancing the additional \$12,000,000 required to complete the construction of the building.<sup>79</sup>

The last alternative was adopted. Messrs. Raskob and du Pont agreed to purchase jointly one-half of the total of \$13,500,000 face amount of second mortgage debentures to be issued by Empire State, Inc. The remaining half of the debenture issue was not taken by the syndicate consisting of the directors of the investment company who had invested \$5,100,000 in the building, but was sold to the newly organized investment company, Chatham Phenix Allied Corporation, which previously had not been in any way connected with the venture. Chatham Phenix Allied Corporation, on February 18, 1930, agreed to purchase \$6,750,000 face amount of the 7% debentures of Empire State, Inc. due in 1948 and secured by a second mortgage on the Empire State Building, at a 10% discount from the face value for a total consideration of \$6,075,000.<sup>80</sup> In addition, Chatham Phenix Allied Corporation was to receive as a bonus 15,000 shares of the common stock of Empire State, Inc.<sup>81</sup>

Mr. Kaufman contended that the purchase by Chatham Phenix Allied Corporation of the debentures of Empire State, Inc. was a "prime investment."<sup>82</sup> However, the fact is that the "primeness" of the investment which constituted 12% of the \$50,000,000 of the total assets of Chatham Phenix Allied Corporation was determined by those individuals whose pecuniary interest was directly affected by the sale of these debentures to the investment company.<sup>83</sup> Eleven of the fifteen directors of the investment company who approved the purchase of the debentures were members of the Waldorf Astoria Building Syndicate.<sup>84</sup> Mr. Kaufman conceded that no independent analysis of the merits of the investment in the Empire State, Inc., second mortgage debentures as compared to existing first mortgage industrial bonds of other companies had been made by any person representing the public investors in the investment company—investors to whom only the non-voting stock of Chatham Phenix Allied Corporation had been sold. He testified.<sup>85</sup>

Q. Did you see if you could buy first-mortgage bonds at a discount of 10% at this time?

A. I don't recall that I checked into it at that time.

Q. Did you give any thought at that time before you made this investment of [\$6,075,000] as to \* \* \* [the] discounts [at which] you could buy industrial bonds?

A. I don't recall having checked it at that time; no, sir.

<sup>79</sup> Id., at 15506-11 and Commission's Exhibit No. 1600.

<sup>80</sup> Id., Commission's Exhibit No. 1600.

<sup>81</sup> Id., at 15522-3, and Commission's Exhibits Nos. 1600 (p. 2) and 1697.

<sup>82</sup> Id., at 15516.

<sup>83</sup> Id., at 15522. These interested directors who were also members of the syndicate were Louis G. Kaufman, Samuel McRoberts, Frank Phillips, E. P. Earle, E. F. Hutton, F. M. Kirby, S. B. Thorne, J. F. Talcott, Edgar S. Bloom, Richard H. Higgins, and William B. Joyce. Furthermore, Messrs. Earle, Kaufman, McRoberts, and Higgins constituted four of the five voting trustees of the stock of the security affiliate. (See *supra*.) As has been pointed out, the security affiliate owned all the 100,000 shares of the voting stock of Chatham Phenix Allied Corporation.

<sup>84</sup> Op. cit. *supra*, note 1. Commission's Exhibit No. 1598.

<sup>85</sup> Id., at 15520-2.



Q. Do you remember whether you made any study at that time as to what first-mortgage bonds and second-mortgage bonds were selling in the market, and at what discounts?

A. I don't recall that I did, but I may have. We may have done that through some allied department or somewhere in the bank, but I didn't personally.

Q. Well \* \* \* if you were going to go through with the plan [for the erection of the Empire State Building] as originally contemplated, there was \$12,000,000 needed, and unless you could raise that \$12,000,000 you might be faced with some reorganization plan which would or might affect or even \* \* \* possibly, wipe out the \$10,000,000 of common and preferred [of Empire State, Inc.] isn't that so?

A. That is always a possibility, but in this case I don't think so.

\* \* \* \* \*

Q. There was no independent judgment exercised upon that transaction in the sense that there were any representatives of the stockholders who had contributed \$47,500,000 for the nonvoting stock, was there?

A. I don't get that.

Q. You remember that this corporate set-up of the trust was that there was 100,000 shares of voting stock, which the security affiliate took and 1,900,000 shares of common nonvoting stock was bought by the public, isn't that so?

A. Yes, sir.

Q. And that meant that \$2,500,000 was put in by the security affiliate, Chatham Phenix Corporation, and there was \$47,500,000 put in by the public, that is so, isn't it?

A. Apparently; \* \* \* I don't recall the figures.

\* \* \* \* \*

Q. And the set-up was that the other stockholders didn't have a single vote. It was just the security affiliate that had votes and the officers and directors of the security affiliate were the ones who were on the board of directors of the investment trust [Chatham Phenix] Allied Corporation, and they passed on the advisability of and fairness and soundness of the \$6,750,000 [face amount] investment, isn't that right?

A. Yes, sir.

Q. Although some of these individuals were members of the syndicate which owned common and preferred stock [of Empire State, Inc.] at the time?

A. True.

Mr. Kaufman further testified:<sup>86</sup>

Q. I have just one observation or one difficulty. The Board of Directors of the [Chatham Phenix] Allied Corporation were all officers and directors of the bank, isn't that so?

A. Substantially so; yes.

Q. Or the security affiliate?

A. I believe so.

Q. And the fact of the matter is that some of the participants in the Waldorf Syndicate, which had five million dollars of common and preferred stock [of Empire State, Inc.] were also members of the Board of Directors of the investment company, the [Chatham Phenix] Allied Corporation?

A. Many of them; yes.

Q. So that although that was your honest judgment at that time, those directors of [Chatham Phenix] Allied Corporation, of course, had a pecuniary interest in the situation?

A. I don't think that would influence one iota the character of the men we had on that board.

Q. I am not saying it did. Mr. Kaufman, I am just stating the fact is you had a pecuniary interest.

A. Yes; we did have.

At the time of the purchase by Chatham Phenix Allied Corporation of the \$6,750,000 face amount of Empire State, Inc., debentures, the Empire State Building was still being constructed and was not completed until May 1931, one year later.<sup>87</sup>

<sup>86</sup> Id., at 15514-5.

<sup>87</sup> Id., at 15517.

Leasing of space in the building proved exceedingly difficult. From May 1, 1931, to August 24, 1932, only 463,705 square feet of space or 25% of the 1,900,000 square feet of available space were leased in the building.<sup>88</sup> On October 22, 1931, the directors of Chatham Phenix Allied Corporation estimated the prospective operating deficit of Empire State, Inc., for the year to end on August 31, 1932, at \$3,746,500.<sup>89</sup>

On August 17, 1931, when Atlas Corporation acquired control of Chatham Phenix Allied Corporation, the Empire State, Inc. debentures were still in the portfolio of that investment company; but almost immediately thereafter, Atlas Corporation entered into negotiations with Louis G. Kaufman, the president of the bank and the largest participant in the Empire State Building syndicate for the sale to him of these Empire State, Inc. debentures. On October 28, 1931, an agreement<sup>90</sup> was concluded between Chatham Phenix Allied Corporation and Mr. Kaufman whereby he agreed to transfer to the investment company 48,000 shares of the stock of Chatham Phenix National Bank & Trust Company in exchange for the Empire State, Inc. debentures and common stock held by the investment company.<sup>91</sup> The investment in these debentures of Empire State, Inc. had cost the investment company a total of \$6,075,000. The 48,000 shares of the stock of Chatham Phenix National Bank & Trust Company received in exchange for these debentures had a market value of \$1,584,000.<sup>92</sup> Thus, by this exchange Chatham Phenix Allied Corporation suffered a loss of \$4,491,000 at the time. Ultimately the loss on this entire transaction was increased to \$5,410,930 by reason of further depreciation in the bank stock received in exchange, accrued interest, and other items.<sup>93</sup>

As has been pointed out, Chatham Phenix National Bank & Trust Company lent to the Waldorf Astoria Building Syndicate (whose members were the officers and directors of the investment company, the bank, and the security affiliate) the sum of \$2,700,000. The security affiliate lent the syndicate \$2,400,000.<sup>94</sup> These loans were secured by one-half of the common and preferred stock of Empire State, Inc. taken down by the subscribers to the syndicate under the syndicate arrangement.<sup>95</sup>

<sup>88</sup> Id., Commission's Exhibit No. 1609 (p. 4).

<sup>89</sup> Id., Commission's Exhibit No. 1610 (pp. 1-2).

<sup>90</sup> Id., Commission's Exhibit No. 1607.

<sup>91</sup> An arrangement was made whereby the 48,000 shares of bank stock were conveyed by Mr. Kaufman to a corporation known as Sealcor Corporation in consideration for the issuance to him of all its capital stock. Mr. Kaufman then conveyed the Sealcor Corporation stock in exchange for the debentures and other securities of Empire State, Inc., held by the investment company to Chatham Phenix Allied Corporation. This method was presumably adopted in order to avoid a double liability upon the bank stock in the event of the bank's failure. (Id., at 15533.)

<sup>92</sup> Op. cit., supra, note 1, at 15533-4.

<sup>93</sup> Ibid. Sealcor Corporation (see note 91, supra) was dissolved on December 8, 1933, the same day that Securities Allied Corporation, formerly Chatham Phenix Allied Corporation, was dissolved. Its assets, paid to Securities Allied Corporation, amounted to \$844,587.12. This, together with commissions and accrued interest, less dividends paid to Securities Allied Corporation, resulted in a total net loss on the investment in the Empire State, Inc. second mortgage debenture situation by the investment company of \$5,410,930.38. (Derived from supplementary information supplied the Commission for Chatham Phenix Allied Corporation.)

<sup>94</sup> Op. cit. supra, note 1, at 15486-7.

<sup>95</sup> Id., at 15541.

On February 5, 1931 the security affiliate, in order to reduce its open account borrowings from the investment company, Chatham Phenix Allied Corporation, which then stood at \$12,700,000, transferred to the investment company a note in the sum of \$2,200,000 then due from the syndicate to the security affiliate.<sup>96</sup> The collateral held for this note and for the loan of \$2,700,000 to the syndicate by Chatham Phenix National Bank & Trust Company was to secure "equally and ratably" the obligations of the syndicate to the bank and to the investment company. On April 3, 1931, however, this agreement<sup>97</sup> with respect to the collateral was modified to provide that the proceeds of any collateral and the payments made by the syndicate members were to be applied first to the satisfaction of the bank's loan and thereafter to the note of the syndicate held by the investment company. The provision was as follows:<sup>98</sup>

This is to confirm the agreement between the undersigned as manager of the above syndicate, and each of you, that all amounts received by the undersigned from members of such syndicate in payment of the syndicate subscriptions, shall be applied against the indebtedness of the syndicate to the Chatham Phenix National Bank and Trust Company until that indebtedness is paid in full, and thereafter all such amounts shall be applied against the indebtedness of the syndicate to Chatham Phenix Allied Corporation, until that indebtedness is paid \* \* \*.

The effect of this agreement of April 3, 1931 was to create a preference to the bank, although both loans were originally on a parity and secured by the same collateral, and to subordinate the loan of the investment company to that of the bank without consideration therefor. Although the bank was eventually paid in full, the investment company, on the other hand, did not receive payment in full, but sustained a loss of \$380,063.33.<sup>99</sup>

Samuel McRoberts, one of the syndicate members, at the time of the public examination (May 13, 1937), was still indebted to the trustees in dissolution of Chatham Phenix Allied Corporation (which was dissolved in 1933) in the approximate sum of \$245,000, which together with interest amounted to \$257,720 as of the liquidation date.<sup>100</sup> In addition to the sum due from Mr. McRoberts, settlements of the obligations of Frank Phillips, William B. Joyce, and Max Weil, other syndicate members, resulted in a loss to Chatham Phenix Allied Corporation of \$122,342.74.<sup>101</sup>

The total loss on the corporation's participation in the Empire State Building financing, including the loss of \$380,063.33 suffered by defaults of the syndicate members on their obligation to pay a total of \$2,200,000 to Chatham Phenix Allied Corporation, was, therefore, \$5,790,993.

<sup>96</sup> Id., Commission's Exhibit No. 1608.

<sup>97</sup> Ibid.

<sup>98</sup> Id., at 15541-2 and Commission's Exhibit No. 1608.

<sup>99</sup> Id., at 15489 and derived from supplementary information supplied the Commission for Chatham Phenix Allied Corporation.

<sup>100</sup> Op. cit. supra, note 1, at 15489 and derived from supplementary information supplied the Commission for Chatham Phenix Allied Corporation. As of April 12, 1939, there was no change in the status of the indebtedness of Mr. McRoberts to Securities Allied Corporation, in Liquidation.

<sup>101</sup> Op. cit. supra, note 1, at 15489.

### 3. MARKET SUPPORT OF BANK STOCK BY THE INVESTMENT COMPANY

Following the market crash of October of 1929, the funds of the Chatham Phenix Allied Corporation were utilized to support the market price of the stock of Chatham Phenix National Bank & Trust Company. According to the minutes of December 16, 1929 of the executive committee of the investment company, it was the consensus of opinion of that committee, all the members of which were directors of the bank, that "there should be no limit placed at this time on the number of shares of Chatham Phenix National Bank & Trust Company capital stock that may be purchased, but that the corporation should be authorized to make purchases and sales for the purpose of supporting the stock at levels on a parity with comparable bank stocks."<sup>102</sup> From October 25, 1929 to April 28, 1930 Chatham Phenix Allied Corporation purchased 49,495 shares of the bank stock at a cost of \$6,140,165.73, and resold the same number of shares for a total of \$6,166,504.71.<sup>103</sup> On April 28, 1931, Chatham Phenix Allied Corporation resumed trading in the bank stock and by November of 1931 purchased 13,729 shares for \$745,696.33 and sold 11,494 shares for \$575,280.76; the remaining shares were sold in February 1932 for \$56,002.66. In all, Chatham Phenix Allied Corporation, from its inception to November 1931, purchased 63,224 shares of the bank stock at a cost of \$6,885,862.06 and sold these shares for total proceeds of \$6,797,788.13, for a net loss of \$88,073.93.<sup>104</sup> These purchases of the bank's stock aggregated cumulatively 4% of the stock of the bank outstanding during the period of the trading.<sup>105</sup>

### 4. MAINTENANCE OF MARKET IN INVESTMENT COMPANY STOCK

In addition to supporting the market in the bank stock, the investment company conducted extensive trading operations in its own nonvoting capital stock which was originally sold to the public. Obviously a decline in the market price of the stock of an investment company associated with a bank would reflect on the prestige and financial stability of the bank. Mr. Kaufman, the president of the bank and a director of the investment company, testified:<sup>106</sup>

Q. Now, in the popular mind, just as there was a tendency to judge the solvency or financial condition of the bank by the behavior of the stock of the security affiliate and it had undesirable effects on the banking institution such as withdrawals of deposits, you understand that——

A. Yes, sir.

Q. You had a similarly undesirable consequence when the stock of an investment trust which was sponsored by the bank did not behave well, isn't that so?

A. Yes, sir.

<sup>102</sup> Id., at 15565.

<sup>103</sup> Id., at 15567 and Commission's Exhibit No. 1613.

<sup>104</sup> Ibid.

<sup>105</sup> Id., at 15567.

<sup>106</sup> Id., at 15553.

Q. So that people seeing the Chatham Phenix Allied Corporation stock falling, it naturally had a tendency possibly to cause a loss of confidence in the bank.

A. That is true.

Q. Which brings on runs?

A. Yes, sir.

From January 3, 1930 to August 11, 1931 Chatham Phenix Allied Corporation, at an aggregate cost of \$10,131,079.45, repurchased 565,564 outstanding shares of its own nonvoting stock,<sup>107</sup> or an amount equal to 30% of the 1,900,000 shares of such stock originally sold. The repurchases of these shares were effected by the investment company at prices below their then asset value. These repurchases accounted for approximately 59% of the volume of trading in the investment company stock on the New York Curb Exchange.<sup>108</sup> In the same period, the corporation sold, largely through dealers and not on the New York Curb Exchange, a total of 165,586 shares for \$3,238,731.66.<sup>109</sup>

Purchases by the investment company of its own stock were made on a commission basis and the bulk of the sales were consummated on a concession basis, resulting in the payment of considerably more than the regular brokerage rates.<sup>110</sup> The sales on a concession basis were executed at market prices, less transfer taxes, and a concession of \$1.00, \$1.12 $\frac{1}{4}$  or 50¢ per share.<sup>111</sup> In making these sales, the company may be said to have suffered trading losses roughly equal to the concessions allowed.<sup>112</sup>

As at August 17, 1932, when Atlas Corporation acquired control of Chatham Phenix Allied Corporation, the latter company held 399,978 shares of its nonvoting stock as treasury stock at a cost of \$6,892,347.79.<sup>113</sup> Immediately thereafter, Atlas Corporation caused this treasury stock to be retired.<sup>114</sup>

## 5. LOANS AND INVESTMENTS BY CHATHAM PHENIX ALLIED CORPORATION

The investment company sustained substantial losses on the total of approximately \$13,000,000 of loans and investments which involved officers, directors, and companies with which the sponsor or its directors and officers were connected. The amount of these loans or investments, with the losses sustained by the investment company, were as follows:<sup>115</sup>

<sup>107</sup> Id., Commission's Exhibit No. 1618 (Schedule 2).

<sup>108</sup> Ibid.

<sup>109</sup> Ibid.

<sup>110</sup> Derived from supplementary information supplied the Commission for Chatham Phenix Allied Corporation.

<sup>111</sup> Ibid.

<sup>112</sup> Ibid. While there are other methods of computing trading results, on a "first in-first out" basis there was a loss of \$392,910.31. This loss was reflected on the books of the company in the average cost of the remaining long position in the stock. (Ibid.)

<sup>113</sup> Op. cit. supra, note 1, Commission's Exhibit No. 1618.

<sup>114</sup> Op. cit. supra, note 11, Pt. II (Schedule 19).

<sup>115</sup> Op. cit. supra, note 110 and op. cit. supra, note 1, at 15584-5.

	<i>Original cost</i>	<i>Loss</i>
Empire State, Inc. (second mortgage debentures) --	\$6,075,000.00	\$5,410,930.38
Waldorf Astoria Building Syndicate (loan) -----	2,200,000.00	<sup>116</sup> 380,063.33
A. F. Gillmore (treasurer of Chatham Phenix Allied Corporation) (loan) -----	13,200.00	<sup>117</sup> 10,617.19
Phillips Petroleum Corporation (investment) -----	1,229,350.00	938,689.00
Consolidated Cigar Corporation (investment) -----	1,072,920.00	693,078.40
General Theatres Equipment, Inc. (investment) --	1,125,000.00	1,056,050.00
Spiegel, May, Stern Co., Inc. (investment) -----	893,326.00	367,198.35
Great American Insurance Co. (investment) -----	165,073.38	56,891.52
National Surety Co. (investment) -----	149,265.00	<sup>118</sup> 69,265.00
Kansas City Southern Ry. Co. (investment) -----	129,195.00	116,179.00
	<hr/> \$13,052,329.38	<hr/> \$9,098,962.17

With respect to the loss of \$693,078.40 on the investment of \$1,072,920 in the 21,500 shares of common stock of Consolidated Cigar Corporation, Samuel McRoberts, president and a director of the investment company, had been a director of Consolidated Cigar Corporation from 1928; William B. Joyce was a director of both Consolidated Cigar Corporation and the investment company in 1928 and 1929; and Paul Christian, vice president of the investment company, was also vice president and a director of Consolidated Cigar Corporation in 1930.<sup>119</sup> Corner, Linder & Co., Inc., investment counsel, retained by Chatham Phenix Allied Corporation to survey Consolidated Cigar Corporation, in its preliminary report stated that the situation was "one of extreme uncertainty."<sup>120</sup> Nevertheless the stock was purchased. Mr. McRoberts testified:<sup>121</sup>

Q. In connection with that, the expert whom you retained on October 25, 1929, I assume he made a report before you bought the stock [of Consolidated Cigar Corporation] when he said "our conclusion in the situation is one of extreme uncertainty."

Do you remember what impelled the [Chatham Phenix] Allied Corporation to make an investment aggregating \$1,072,920, or 21,500 shares at an average price of \$49.90 a share?

A. We believed it was a good buy, that is all I can say.

In connection with the loss of \$1,056,050 sustained on the investment in stock of General Theatres Equipment, Inc., a loan of \$5,000,000 was made by Electrical Research Products, Inc., a wholly owned subsidiary of Western Electric Company, Inc., to Harley L. Clarke, president of General Theatres Equipment, Inc. Chatham Phenix Allied Corporation agreed to participate in this loan to the extent of \$2,500,000. However, in lieu of making the loan in this amount, Chatham Phenix Allied Corporation purchased from Harley L. Clarke 30,000 shares

<sup>116</sup> Of this amount \$257,720.59 was the sum of \$245,699.04 plus interest, owed by Samuel McRoberts, still carried on the books of the company as an account receivable at time of liquidation. (Op. cit. supra, note 11, Pt. II, Schedule 5.)

<sup>117</sup> Amount still carried on the books of the company as an account receivable at the time of liquidation. (Ibid.)

<sup>118</sup> This figure represents the depreciation suffered in this investment as at December 31, 1930. (Op. cit. supra, note 11, Pt. III.) Accurate figures for actual loss are not available.

<sup>119</sup> *Moody's Manual of Investments, Industrials, etc.*, 1929, p. 1871; id., 1930, p. 141; id., 1931, p. 1062; id. 1932, p. 1062. During this period, Chatham Phenix National Bank & Trust Company was the transfer agent.

<sup>120</sup> Op. cit. supra, note 1, at 15583 and Commission's Exhibit No. 1616.

<sup>121</sup> Id., at 15584.

of the stock of General Theatres Equipment, Inc. for \$1,125,000, and purchased a note made by Mr. Clarke and endorsed by Electrical Research Products, Inc. for the balance amounting to \$1,375,000, from Electrical Research Products, Inc.<sup>122</sup> The note was paid but the stock was subsequently liquidated at a loss of \$1,056,050.<sup>123</sup> Edgar S. Bloom, a director of Chatham Phenix Allied Corporation, was a director and president of Western Electric Company, Inc., the parent company of Electrical Research Products, Inc., and also a director of that company. William B. Joyce, a director of Chatham Phenix Allied Corporation, was also a director of Western Electric Company, Inc.<sup>124</sup>

The investment company also had interlocking director connections with the following companies in which it had made investments: Spiegel, May, Stern Co., Inc.,<sup>125</sup> Great American Insurance Company,<sup>126</sup> Kansas City Southern Railway Company,<sup>127</sup> National Surety Company,<sup>128</sup> and Phillips Petroleum Corporation.<sup>129</sup>

With respect to an investment in Film Securities Corporation 2-year 6% secured gold notes,<sup>130</sup> Chatham Phenix Corporation, the sponsor of the investment company, pursuant to a syndicate participation, purchased its 5% allotment and received, as a bonus for the participation therein, 2,500 shares of common stock. Immediately thereafter, the sponsor sold its full allotment to the investment company, but the sponsor retained for itself the bonus consisting of 2,500 common shares. Mr. McRoberts' explanation of this transaction was as follows:<sup>131</sup>

<sup>122</sup> Id., at 15600-2, Commission's Exhibit No. 1619 and derived from supplementary information supplied the Commission for Chatham Phenix Allied Corporation.

<sup>123</sup> Ibid.

<sup>124</sup> *Moody's Manual of Investments, Public Utilities, etc.*, 1931, p. 133.

<sup>125</sup> The investment company's sponsor, Chatham Phenix Corporation, had been the principal underwriter for Spiegel, May, Stern Co., Inc. (American Underwriting Houses and their Issues, 1925 to November 1st, 1928, p. 219.) Rollin C. Bortle, president of the security affiliate, and a director of the investment company, was also a director of Spiegel, May, Stern Co., Inc. in 1929. Wallace T. Perkins, a director of the bank was a director of Spiegel, May, Stern Co., Inc. in 1929 and 1930. C. H. Jones, vice president of the security affiliate, was a director of Spiegel, May, Stern Co., Inc. in 1930 and 1931. (*Moody's Manual of Investments, Industrials*, 1930, p. 232; id. 1931, p. 1115; id., 1932, p. 1146; *Moody's Manual of Investments, Banks, etc.*, 1930, p. 164; id., 1931, p. 326.) During this period, Chatham Phenix National Bank & Trust Company was the transfer agent.

<sup>126</sup> William H. Koop was president and a director of Great American Insurance Company, while a director of the bank. Samuel McRoberts, president of the investment company, was also a director of Great American Insurance Company. (*Moody's Manual of Investments, Banks, etc.*, 1930, p. 2426; id., 1931, p. 1946; id. 1932, p. 1547.)

<sup>127</sup> Samuel McRoberts was a director of the Kansas City Southern Railway Company in 1929 and 1930. (*Moody's Manual of Investments, Railroads*, 1930, p. 1063; id., 1931, p. 730.)

<sup>128</sup> William B. Joyce, Edgar S. Bloom and Samuel McRoberts, all directors of the investment company and the security affiliate, were directors of National Surety Company. (*Moody's Manual of Investments, Banks, etc.*, 1930, p. 2106; id., 1931, p. 1942; id., 1932, p. 1909.)

<sup>129</sup> Mr. Phillips, a director of the investment company, was president of Phillips Petroleum Corporation. Messrs. McRoberts, Higgins, Earle and du Pont, directors of the investment company, were also directors of Phillips Petroleum Corporation. (Derived from supplementary information supplied the Commission for Chatham Phenix Allied Corporation.)

<sup>130</sup> Op. cit. supra, note 1, at 15575.

<sup>131</sup> Id., at 15576.

Q. What I can't understand is why the common stock was not turned over to the [Chatham Phenix] Allied Corporation at the time the [Chatham Phenix] Allied Corporation bought the thing or took over your participation.

A. The Chatham Phenix Corporation would probably have insisted on selling to somebody else if we insisted on the stock also.

Q. So in that situation the Security Corporation just sold the notes?

A. Just as the syndicate sold them.

Q. And kept all the common stock?

A. I suppose they thought that was their commission probably for handling the transaction. If they had not sold them to us, they would have sold them to somebody else.

A comparison has been made of the depreciation in value of investments made in companies with interlocking directorates with the investment company and of the depreciation in value of investments made in companies which had no connection with the sponsors or the officers or directors of the investment company. The following figures show the original cost of the securities, their market value, and the depreciation as at December 31, 1930 of the companies with which there was some affiliation.<sup>132</sup>

	Original cost	Market value	Depreciation
Phillips Petroleum Corporation.....	\$1, 229, 350. 00	\$466, 200. 00	\$763, 150. 00
Consolidated Cigar Corporation.....	1, 060, 665. 00	548, 600. 00	512, 065. 00
General Theatres Equipment, Inc.....	1, 126, 500. 00	367, 500. 00	759, 000. 00
Spiegel, May, Stern Co., Inc.....	136, 526. 85	24, 700. 00	111, 826. 85
Spiegel, May, Stern Co., Inc. (preferred).....	438, 920. 50	68, 339. 12	370, 581. 38
Great American Insurance Co.....	165, 073. 38	108, 750. 00	56, 323. 38
National Surety Co.....	149, 265. 00	80, 000. 00	69, 265. 00
Kansas City Southern Ry. Co.....	129, 195. 00	55, 200. 00	73, 995. 00
	4, 435, 495. 73	1, 719, 289. 12	2, 716, 206. 61

These figures indicate a shrinkage of 61.2% in these investments.<sup>133</sup>

Investments made in companies with no apparent association or connection with the officers or directors or sponsors of the investment company, show a depreciation of only 29.7% :

	Original cost	Market value	Depreciation
Investments in unrelated companies <sup>134</sup> .....	\$21, 730, 356. 95	\$15, 269, 268. 39	\$6, 461, 088. 56

<sup>132</sup> Op. cit. supra, note 11, Pt. III (Table 2).

<sup>133</sup> These investments do not include the second mortgage debentures of Empire State, Inc. carried then at a value equal to their cost of \$6,075,000, although the investment company sustained a loss of \$4,491,000 shortly thereafter on their exchange with Louis G. Kaufman for 48,000 shares of Chatham Phenix National Bank & Trust Company stock, and ultimately a loss on the whole transaction of \$5,410,930. Had the investment in these bonds been included in the above list, even on the basis of the smaller loss of \$4,491,000 in lieu of larger eventual depreciation, the percentage of shrinkage would be 68.6%.

<sup>134</sup> These figures include the amount invested in bonds, exclusive of Empire State, Inc. debentures. Out of a total investment in bonds (excluding the Empire State, Inc. debentures) the investment company's books reflect a shrinkage of \$481,733.18.



## E. Transfer of Control of Chatham Phenix Allied Corporation to the Atlas Corporation

By July 1931, Chatham Phenix National Bank & Trust Company began to experience runs on its various branches.<sup>135</sup> The management of the bank had become convinced that the bank should be completely divorced from the investment company. Mr. Kaufman, the president of the bank, when examined on this aspect of the relationship, testified:<sup>136</sup>

Q. So that when the Chatham Phenix Allied Corporation stock began to fall, it naturally had a tendency to cause a loss of confidence in the bank.

A. That is true.

Q. Which brings on runs.

A. Yes, sir.

Q. And I am not making a very wide assumption when I say that that may have been one of the things that motivated the banking interests who indirectly controlled the investment trust to accede to the transfer of control of the investment trust, isn't that so?

A. That is true.

Q. You had the situation where the name of the bank was tied up with the investment trust, and when the market prices declined in the shares of that trust, it necessarily had to be reflected in the confidence of the depositors in the bank even though they were separate and distinct institutions.

A. True, I agree with you absolutely, that there should be no connection between a bank operating itself and an investment company, in the face of all that has happened—I agree with you.

When examined on the affiliation of banks and investment companies, Mr. McRoberts, chairman of the board of directors of the bank, testified:<sup>137</sup>

A. My experience was that if I was doing it today, I wouldn't do it at all, and I would never have formed the corporation, but that is hindsight, that is an after point of view.

Q. I am mindful of that, and I suppose that you don't have any objection, General, to our getting the benefit of hindsight, because we are looking into the future, you see. Now you said that you would not form it at all. Do you mean that you would not form this company, this specific company, because of the losses it sustained, or you would not have a bank or security affiliate ever form an investment trust?

A. I think that the whole theory of affiliated investment companies with banks was a mistake, especially where it was a distributing corporation.

The management had the alternatives either to dissolve Chatham Phenix Allied Corporation or to transfer control of that company. The fact that the dissolution of the investment company might be deemed an admission by the bank management of unsuccessful operation and, therefore, a reflection on the bank's prestige and the fact that Chatham Phenix Corporation, a security affiliate of the bank, then owed to Chatham Phenix Allied Corporation the sum of \$10,556,993.73, evidently played an important part in the ultimate determination to transfer control.<sup>138</sup> Mr. McRoberts testified:<sup>139</sup>

<sup>135</sup> Derived from supplementary information supplied the Commission by Atlas Corporation.

<sup>136</sup> Op. cit. supra, note 1, at 15553-4.

<sup>137</sup> Id., at 15431.

<sup>138</sup> Apparently the security affiliate was unable to pay this loan except by selling its large holdings of Chatham Phenix Allied Corporation stock and its few other security holdings. (See note 141 infra.) Floyd B. Odum, president of Atlas Corporation, which purchased these assets from the security affiliate, characterized the indebtedness of the security affiliate to the investment company as "a frozen loan". (Public Examination, Atlas Corporation, at 17578.) Mr. Odum testified that the security affiliate "had no money to pay it," that "they had very few assets," and that he didn't think that the loan "was good". (Id., at 17576-78.)

<sup>139</sup> Id., at 15587-9.

Q. There were no mechanical difficulties to liquidation since Chatham Phenix controlled all the voting stock.

A. No.

Q. You didn't have the problem of preferred and common on your hands?

A. No.

Q. Because everybody was on a parity, isn't that so?

A. Yes, sir.

Q. And you say there might have been resentment against it?

A. I think it would have been resented very much by the stockholders.

Q. Maybe there were other factors [which] you haven't thought about that possibly \* \* \* prevailed so the trust was not liquidated. \* \* \* In the first place the bank was involved in that its name was in the investment trust?

A. Yes, sir.

Q. And it just would not look right, would it, if the investment trust was liquidated. That would be a confession in a way that the management was not successful?

A. I don't think that was the controlling idea. That might be an element. At that time we didn't want to see the Allied stockholders lose money and we were in hopes things would come back and make money, and it was very natural that that rather vetoed any idea of liquidation.

Q. There was another obstacle to liquidation, wasn't there in that at this time, and I am talking about August 11, 1931, Chatham Phenix Corporation, the security affiliate of the bank, owed \$10,566,933.73 to the investment company, [Chatham Phenix] Allied Corporation. Do you recall that?

A. Yes.

Q. So if there was going to be a liquidation, the security affiliate would have to pay the money it owed to the investment company, isn't that so?

A. That is true.

Q. Do you know whether Chatham Phenix Corporation at that time had ten and a half million dollars?

A. They did pay.

Q. We will see how the payment was effected.<sup>140</sup>

The assets of Chatham Phenix Corporation, the sponsor corporation, were stated to have consisted of its holdings of the 100,000 shares of the voting stock and 318,368 shares of the nonvoting stock of the investment company. These two blocks of stock had a combined asset value of \$8,246,033.28 and a total market value of \$6,275,520. The sponsor had other securities with a market value of \$517,900.<sup>141</sup> The total assets of the security affiliate, therefore, on this basis, amounted to \$8,763,933.28 (taking the blocks of the investment company stock at asset value), or approximately \$1,800,000 less than the sum owed in July 1931 by the security affiliate to the investment company.

Prospective buyers of the 100,000 shares of voting stock and the 318,368 shares of nonvoting stock of the investment company held by Chatham Phenix Corporation were sought.<sup>142</sup> Some negotiations were commenced with Tri-Continental Corporation, an investment company sponsored by J. & W. Seligman & Company, an investment banking firm.<sup>143</sup> However, while these negotiations were pending, Mr. Adams of E. F. Hutton & Company, members of the New York Stock Exchange, suggested the Atlas Corporation as a possible purchaser of Chatham Phenix Corporation's holdings in Chatham

<sup>140</sup> The method by which this debt was paid is described *infra*.

<sup>141</sup> Public Examination, Atlas Corporation, Commission's Exhibit No. 2001, p. 107 and also, *op. cit. supra*, note 135. These securities consisted of 12,434 shares of Zonite Products Corp. common stock, 4,375 shares of the preferred and 23,324 shares of the common stock of Spiegel, May, Stern Co., Inc., and 2,475 shares of the common stock and 525 shares of the preferred stock of McKesson & Robbins, Incorporated. (*Op. cit. supra*, note 1, Commission's Exhibit No. 1617.)

<sup>142</sup> *Op. cit. supra*, note 1, at 15590.

<sup>143</sup> *Ibid*.

Phenix Allied Corporation.<sup>144</sup> E. F. Hutton, of E. F. Hutton & Company, was a director of both Chatham Phenix National Bank & Trust Company and Chatham Phenix Allied Corporation. Mr. Adams had apparently been introduced to officials of Atlas Corporation by David G. Baird, one of the several "finders" of investment companies for Atlas Corporation. E. F. Hutton & Company eventually received a finder's fee of \$100,000 and Mr. Baird received the sum of \$59,046.25 from Atlas Corporation.<sup>145</sup>

## 1. SALE OF CONTROL OF THE INVESTMENT COMPANY TO ATLAS CORPORATION

On August 11, 1931 the Atlas Corporation agreed to purchase the 100,000 shares of voting stock and the 318,368 shares of nonvoting stock of Chatham Phenix Allied Corporation held by Chatham Phenix Corporation at a price of \$20 per share or a total consideration of \$8,367,360.<sup>146</sup> The shares of Chatham Phenix Allied Corporation then had an asset value of \$19.71 per share, and a market value of \$15.00 per share.<sup>147</sup> The price paid by Atlas Corporation for the stock was, therefore, \$121,326.72 in excess of the asset value of the stock and \$2,091,840 in excess of market value. The agreement for transfer of control also provided "it is to be understood that the market in the shares of Chatham Phenix Allied Corporation is to be in our (Atlas Corporation) sole control from now on and, to that end, your Corporation and its affiliates shall not deal further in such shares without our previous consent." A further provision required "Chatham Phenix" to be eliminated from the name of the company.<sup>148</sup>

In addition, Atlas Corporation agreed to purchase, at the market price, all the other securities in the portfolio of the Chatham Phenix Corporation, which constituted the balance of its assets.<sup>149</sup>

No disclosure with respect to the transfer of control by the sponsor, Chatham Phenix Corporation, to the Atlas Corporation was made by the sponsor to the stockholders until after the sale of the stock had been consummated. The president, Samuel McRoberts, testified:<sup>150</sup>

Q. So that the Chatham Phenix Corporation, which sponsored [the investment trust] \* \* \* and was in absolute control of the investment trust throughout this entire period, both by the ownership of every share of voting stock and by all the officers and directors, and Chatham Phenix Corporation which was the underwriter and distributor of the stock to the public turned over the control of this investment trust to the Atlas interests before it even disclosed it to the stockholders?

A. What?

Q. Before it was disclosed to these stockholders?

A. Yes, that is true.

<sup>144</sup> Public Examination, Atlas Corporation, at 17791.

<sup>145</sup> Id., Commission's Exhibit No. 1969.

<sup>146</sup> Op. cit. supra, note 1, Commission's Exhibit No. 1617.

<sup>147</sup> Id., at 15596 and Commission's Exhibit No. 1618.

<sup>148</sup> Id., Commission's Exhibit No. 1617.

<sup>149</sup> These securities were acquired, however, not by Atlas Corporation but by Chatham Phenix Allied Corporation, which on August 17, 1931, the date Atlas Corporation actually acquired control of Chatham Phenix Allied Corporation, purchased these securities from Chatham Phenix Corporation for \$517,900, their then market value. (Op. cit. supra, note 144, Commission's Exhibit No. 2001, p. 107.)

<sup>150</sup> Op. cit. supra, note 1, at 15595-6.

Although the security affiliate received \$20 per share for its voting and nonvoting stock, no provision for equal treatment was made for public stockholders. Mr. McRoberts testified:<sup>151</sup>

Q. Now, in getting \$20 a share, which was \$1 [sic \$.29] above the asset value and approximately \$5 above the market on these 418,000 shares of common stock, that means they paid you approximately \$2,000,000 above the market for that block, isn't that so?

A. Well, they paid \$20.

Q. And the market you said was \$14.50 [sic \$15.00]?

A. Well, that is the way I recall it. I don't know of course, if you were to start out to buy the stock in any such amount, you would put the market up very materially.

Q. And if you were selling the block?

A. It would have gone the other way, yes.

Q. You don't deny you got a good price under the circumstances?

A. I got the best price I could.

Q. But as far as the other stockholders were concerned, there was no provision to get them the best price?

A. No, but I think it was doing a good service to the other stockholders when we did what we did.

Q. Did the Chatham Phenix Corporation retain any portion of that stock in the [Chatham Phenix] Allied Corporation so that they could avail themselves of a good service that was being rendered to the stockholders?

A. No, I don't think so.

Q. They sold every single share?

A. That was a condition of the trade.

## 2. FINANCING BY ATLAS CORPORATION OF THE PURCHASE OF CHATHAM PHENIX ALLIED CORPORATION

Atlas Corporation did not, at the date of the contract, have available the \$8,367,360 in cash required to consummate the purchase of the 100,000 shares of voting stock (all of the outstanding voting shares) and the 318,368 shares of nonvoting stock of Chatham Phenix Allied Corporation. In order to make the down payment of \$1,367,360 due under the contract on August 12, 1931, Atlas Corporation borrowed that sum from General Empire Corporation, one of Atlas Corporation's subsidiaries.<sup>152</sup>

On August 17, 1931, Atlas Corporation paid the balance of the purchase price, \$7,000,000, by means of a loan from the Bankers Trust Company of New York. All of the directors of Chatham Phenix Allied Corporation resigned, and were replaced by representatives of Atlas Corporation and the name of the acquired investment company was then changed to Securities Allied Corporation. The \$8,885,260 received by Chatham Phenix Corporation from the sale to Atlas Corporation of its stock in Chatham Phenix Allied Corporation and by the sale of the remaining securities in its portfolio were used together with funds borrowed by the security affiliate from Chatham Phenix National Bank & Trust Company to repay on August 17, 1931, the long outstanding debt of \$10,556,993.73 of the security affiliate to Chatham Phenix Allied Corporation, the investment company.<sup>153</sup> In this manner, Atlas Corporation ultimately obtained control of the funds paid by it to Chatham Phenix Corporation, for the blocks of the investment company stock which Atlas

<sup>151</sup> Id., at 15596-8.

<sup>152</sup> Op. cit. supra, note 144, Commission's Exhibit No. 2001 (p. 108).

<sup>153</sup> Op. cit. supra, note 135.

Corporation purchased. Atlas Corporation not only acquired control over approximately \$10,000,000 of which \$8,367,360 were the very funds used by Atlas Corporation to secure control of the investment company, but also acquired control of the approximately \$21,000,000 of other assets held by Chatham Phenix Allied Corporation.<sup>154</sup>

In order to secure funds to repay its loans from General Empire Corporation and Bankers Trust Company totaling \$8,367,360, Atlas Corporation itself and through several of the investment company subsidiaries on August 17, 1931 (the date on which Atlas Corporation acquired control of Chatham Phenix Allied Corporation), sold over \$8,000,000 of their holdings of stocks of other investment companies to Chatham Phenix Allied Corporation.<sup>155</sup> With proceeds of the sales of these securities to its newly acquired investment company, Atlas Corporation then discharged its obligations to General Empire Corporation and Bankers Trust Company. These securities of other investment companies which were sold by Atlas Corporation and its affiliated companies to Chatham Phenix Allied Corporation constituted at that date approximately 26% of the net assets of this newly acquired investment company. This change in the investment policy of Chatham Phenix Allied Corporation whereby that investment company substantially became a holding company of other investment companies was effected without the prior knowledge of its stockholders, although Mr. McRoberts had known, prior to the transfer of control, that this change of policy was contemplated. Mr. McRoberts testified:<sup>156</sup>

Q. Was there any discussion with Mr. Odum or any representative of the Atlas Corporation as to what the future investment policy of this investment trust would be?

A. Yes.

Q. What was the discussion about?

A. Well, their policy was to do just what we were doing with our own stock.

Q. What was that?

A. We were buying the stock when it was offered materially below the book value. They were doing it not only with their own stock but with other investment trust stocks. In other words, they were in a position to do it in a very much broader way than we were.

Q. You say Mr. Odum told you that after he got control he was going to use all the funds of the Chatham Phenix Allied Corporation to buy other investment trusts?

A. When he could buy them on that basis. That was his main operation at that time.

Q. What did he say his main operation was?

A. Buying investment trust stocks where they would be bought materially below the liquidating value of the company.

<sup>154</sup> With the net amount of \$6,892,211.49 expended by the investment company on the purchase of its own stock and \$2,640,702.00 paid by the company as dividends on its stocks considered as returns of capital to its security holders, the net capital which had been paid into Chatham Phenix Allied Corporation as at August 17, 1931, when Atlas Corporation acquired control of the corporation, was \$40,467,086.51. On August 17, 1931, the net worth of the corporation was \$31,555,115.22. In the two years of the corporation's operations under the management of Chatham Phenix Corporation, allowing for returns of capital, its assets had shrunk in value by \$8,911,971.29, a shrinkage equivalent to 22% of the net capital contributed to the enterprise. Of the \$31,555,115.22 of net assets, \$10,556,993.73 consisted of the outstanding amount due to the investment company by Chatham Phenix Corporation. (Op. cit. supra, note 144, Commission's Exhibits Nos. 2003, 2043; op. cit. supra, note 1, Commission's Exhibit No. 1618.)

<sup>155</sup> Op. cit. supra, note 144, Commission's Exhibit No. 2001 (p. 109 et seq.).

<sup>156</sup> Op. cit. supra, note 1, p. 15594.

This policy was subsequently continued and the investment company's funds were utilized to purchase substantial interests in nearly all the other investment companies which had been acquired by Atlas Corporation.<sup>157</sup> By December 8, 1933, when Chatham Phenix Allied Corporation was dissolved, an aggregate of \$26,769,284.49 of its assets<sup>158</sup> were invested in the securities of investment companies within the sphere of control of Atlas Corporation, and Chatham Phenix Allied Corporation had become the key company in the Atlas Corporation program of acquisition of other investment companies. At the time when Atlas Corporation had acquired control of Chatham Phenix Allied Corporation, the net assets of Chatham Phenix Allied Corporation had been \$31,555,115, consisting of cash and diversified securities. Atlas Corporation, after securing control of Chatham Phenix Allied Corporation, began to increase its holdings of the nonvoting stock of Chatham Phenix Allied Corporation by purchases and by offers of exchange of Atlas Corporation stock for Chatham Phenix Allied Corporation stock. The purchases and exchanges were effected by Atlas Corporation at prices below the asset value of the Chatham Phenix Allied Corporation stock. Mr. McRoberts knew that Atlas Corporation would make such exchange offers.<sup>159</sup> Not only was the policy of Atlas Corporation disclosed to him but, as he testified,<sup>160</sup> Atlas Corporation had refused to make an offer to acquire the holdings of the general public at the same price paid by Atlas Corporation to the security affiliate, Chatham Phenix Corporation. The agreement of August 11, 1931, between Atlas Corporation and Chatham Phenix Allied Corporation expressly stipulated that Atlas Corporation was to be in sole control of the "market" in shares of Chatham Phenix Allied Corporation.<sup>161</sup>

By December 8, 1933, the date of dissolution of the investment company, Atlas Corporation and its controlled companies had acquired by purchase or exchange approximately 1,000,000 shares of the investment company's nonvoting stock held by the public at prices below asset value.<sup>162</sup> The total holdings of Atlas Corporation and its subsidiaries of voting and nonvoting stock of Chatham Phenix Allied Corporation were 1,434,057 shares or approximately 97% of the total number of shares outstanding at the date of dissolution.<sup>163</sup> The remaining stockholders of Chatham Phenix Allied Corporation on its dissolution received, as their pro rata part of its assets, \$15.31 per share for their stock as compared with the original offering price of \$27 per share. If dividends of \$1.75 paid per share during this period<sup>164</sup> be

<sup>157</sup> A more detailed discussion of the acquisition of control of Chatham Phenix Allied Corporation and its subsequent dissolution is given in Ch. IV of this part of the report.

<sup>158</sup> Op. cit. supra, note 144, Commission's Exhibit No. 2040.

<sup>159</sup> Op. cit. supra, note 1, at 15594.

<sup>160</sup> Id., at 15595.

<sup>161</sup> Id., Commission's Exhibit No. 1617.

<sup>162</sup> Op. cit. supra, note 144, Commission's Exhibit No. 2001 (p. 109 et seq.). Atlas Corporation in 1932 and 1933 acquired in exchange for its own securities 679,948 shares of nonvoting common stock of Chatham Phenix Allied Corporation at a gross difference in the asset value of the securities exchanged as of the date of the exchange of \$3,344,686 in favor of Atlas Corporation. (Id., Commission's Exhibit No. 2001, pp. 116, 119.) As a partial offset, however, by becoming stockholders of Atlas Corporation, as a result of the exchange, the Chatham Phenix Allied Corporation stockholders shared in the asset gain to Atlas Corporation.

<sup>163</sup> Ibid.

<sup>164</sup> *Moody's Manual of Investments, Banks, etc.*, 1933, p. 2496.

deducted from the original offering price of \$27, those stockholders who retained their stock from the inception of the company until its dissolution suffered a loss of \$9.94 per share.<sup>165</sup> Those stockholders who exchanged their shares in 1932 and 1933 for Atlas Corporation securities,<sup>166</sup> as at October 31, 1938, sustained a loss, on the basis of a net investment of \$25.25 in the company,<sup>167</sup> of \$13.02 per share measured by the asset value and of \$16.67 per share measured by the market value of the Atlas Corporation securities received by them.<sup>168</sup>

## V. CENTRAL-ILLINOIS SECURITIES CORPORATION

### A. Summary

Central-Illinois Securities Corporation was organized in October 1929 by Central Trust Company of Illinois, a commercial bank located in Chicago, Illinois, and by Central-Illinois Company, the bank's security affiliate. The sponsors secured control of the investment company at the outset by purchasing from it for \$3,000,000, common stock entitled to 43% of the total voting power of all the stock issued. At the same time they sold to the public allotment certificates representing units of preferred and common stock for \$12,600,000, of which the investment company received \$12,000,000.

The affairs of the investment company were, until November 1932, directed and managed exclusively by individuals connected with the sponsoring bank and its security affiliate, and for several years the investment company was operated substantially as an auxiliary of the sponsors. The funds of the Central-Illinois Securities Corporation were almost intact when the stock market break occurred on October 29, 1929. Two weeks later, at its first business meeting, the interlocking board of directors caused the investment company to make loans to the sponsors and their affiliates and to purchase securities from them in amounts which aggregated \$5,459,966, a sum in excess of one-third of the company's total assets. On most of these transactions the investment company later sustained severe losses.

During the period of the management of the investment company by the bank, loans including brokers' loans aggregating \$13,500,000 were taken over by the investment company from the sponsor bank allegedly pursuant to an unwritten agreement that the bank would repurchase them on demand. Subsequently when the investment company under an independent board of directors invoked the agreement in an effort to recover some of the losses suffered on these transactions, the successor of the sponsor bank rejected the claim on the ground that there was insufficient evidence to justify "an admission of enforceable liability" on the part of the bank.

The investment company devoted over \$6,000,000 or about 40% of its initial capital to two ventures in which its sponsors were interested. In one of these ventures, the investment company, in a futile effort to support the market for the stock of its sponsor bank and the bank's successor, purchased approximately \$1,749,133 of the bank's stock on a collapsing market. This entire investment except the sum of \$105,416 was lost. In addition, the investment company was

<sup>165</sup> Op. cit. supra, note 144, Commission's Exhibit No. 2004.

<sup>166</sup> They received for each share of Chatham Phenix Allied Corporation stock, Atlas Corporation securities which had an asset value of \$12.23 and a market value of \$8.58 as at October 31, 1938, the most recent date for which figures are available. Securities Registration Statement, Atlas Corporation, Form 15, File No. 1-2714-2 (Annual Report for 1938). The Atlas Corporation securities received by the stockholders consisted of one share of Atlas Corporation common stock and one-fifth of one of its warrants. (Op. cit. supra, note 161.)

<sup>167</sup> This net investment basis of \$25.25 is obtained by deducting the cash dividends of \$1.75 from the original offering price of \$27.

<sup>168</sup> At the date of the exchange offer of Atlas Corporation in June 1932, the asset value of the Chatham Phenix Allied Corporation stock was \$8.50 per share and its market value was \$4.50. The average asset value and market value of the Chatham Phenix Allied Corporation stock during the period of the 1933 exchanges were \$13.64 per share and \$6.75 per share respectively. (Id., Commission's Exhibit No. 2001, pp. 115, 118.)



forced to provide \$814,200 more for statutory liability assessments on the bank's stock, thus increasing the final loss in this investment to \$2,457,917.

In the second venture, the Central-Illinois Securities Corporation, together with H. M. Byllesby & Co., arranged to purchase control of a utility holding company for which its parent, Central-Illinois Company, was the banker. Commencing with a participation of approximately \$1,700,000, the investment company, despite an increasingly unfavorable outlook, increased its commitments in the utility company through loans and stock purchases to a total of \$3,770,965. In 1932, after the utility company was placed in receivership, Central-Illinois Securities Corporation charged off \$1,730,691 as a loss on this venture and at the end of 1935 it carried this investment on its books at \$430,875.

Central-Illinois Securities Corporation, at the end of 1935, had sustained realized and unrealized net losses of \$7,315,000 on its loans and transactions in securities. These losses were equal to approximately 49% of the investment company's original capital of \$15,000,000.

Former officers of the investment company testified that the company's difficulties had resulted largely from its interrelationship with the bank and the security affiliate which sponsored it, and from the conflicts of interest which this interrelationship created.

## B. Organization

Central-Illinois Securities Corporation, an investment company of the management type,<sup>1</sup> was organized under the laws of Delaware on October 1, 1929, by Central Trust Company of Illinois, a commercial bank in Chicago, Illinois, and by Central-Illinois Company, a security affiliate of the bank.<sup>2</sup>

Henry M. Dawes, chairman of the board of directors of the investment company,<sup>3</sup> testified that Central-Illinois Securities Corporation was created because the sponsors contemplated that there were mutual benefits to be derived from the operation of the investment company in affiliation with the bank:<sup>4</sup>

<sup>1</sup> Public Examination, Central-Illinois Securities Corporation, Commission's Exhibit No. 239. The offering circular announced: "Central-Illinois Securities Corporation, organized under the laws of Delaware with broad charter powers, may participate in underwritings and syndicates and engage in such other investment activities as its Board of Directors may determine. The Corporation has been organized to supplement the existing facilities of Central Trust Company of Illinois and Central-Illinois Company."

<sup>2</sup> The investment company was controlled by the security affiliate. The security affiliate was in turn controlled by the bank through the usual device of having all the stock of the affiliate held in trust for the benefit of the stockholders of the bank, with a specified number of officers of the bank as trustees. (Op. cit. supra, note 1, at 1848.) In June 1931, the bank was merged with the Chicago Trust Company immediately after the consolidation of the latter with the National Bank of the Republic of Chicago. (Id., at 1862.) The successor bank continued a commercial banking business under the name of Central Republic Bank and Trust Company until October 1932. After October 6, 1932, the activities of the merged bank, Central Republic Bank and Trust Company, were restricted exclusively to a general trust business, its deposits being assumed by the newly formed City National Bank and Trust Company of Chicago and its name was changed to Central Republic Trust Company. (Id., at 1882.) In 1934 the trust company was placed in receivership. (Id., at 1954.)

At the time of the merger of the banks in June 1931, Central Trust Company of Illinois had as its security affiliate Central-Illinois Company; and the National Bank of the Republic of Chicago had a security affiliate named the National Republic Company. Both security affiliates were merged, forming Central Republic Company, its stock being held in trust for the benefit of the stockholders of the successor bank. In the fall of 1931, the stock of Central Republic Company held in trust was distributed to the stockholders of the bank. (Id., at 2125.)

<sup>3</sup> Henry M. Dawes was chairman of the investment company's board of directors from the inception of the company until November 1932. For other connections of Henry M. Dawes and his family see note 5 infra.

<sup>4</sup> Op. cit. supra, note 1, at 1850.



A. \* \* \* The assumption was there was an opportunity for carrying on a business of this kind with the connection that it had which would be mutually beneficial. I really haven't said anything except the obvious things, that a closely associated organization of that kind could be mutually beneficial to the organizations that were operating at that time and to the new organization.

Q. You said the business at that time. What do you mean?

A. The sort of thing I have in mind is participation in underwriting where better terms, perhaps, could be secured for larger participation.

Q. Any other examples?

A. That is all that occurs to me. In other words, I looked on it as the conventional arrangement which was being followed by the larger institutions under "department store" banking, as I would call it, which was conducted at that time.

The directors and all the executive officers of the investment company were either officers or directors of the bank or its security affiliate. The initial board of directors and administrative personnel of the investment company remained in office continuously from October 1929, until November 1932, without substantial change.<sup>5</sup>

Admittedly, this identity of relationship on the part of the interlocking directors and officers resulted in the creation of a dual and frequently conflicting allegiance. Philip R. Clarke, former president of the three companies,<sup>6</sup> in describing this situation stated:<sup>7</sup>

A. \* \* \* And the more conscientious your administrative officers are the more difficult is their problem, and there are some times when it is almost impossible to decide whether or not this should go to your left hand or whether it should go to your right hand. And the result was that I think those of us who comprised that administrative personnel, none of these officers were compensated, and they endeavored to do the very best they could under the existing circumstances and reached the unqualified conclusion that it was an inadvisable and impracticable relationship and one that should be terminated within the shortest possible time.

<sup>5</sup> The following table indicates the interlocking position of the various directors and officers of the investment company:

Office held in the investment company	Office held in the bank	Office held in security affiliate
Philip R. Clarke: President and director..	President and director....	President and director.
R. Floyd Clinch: Director.....	Director.....	
Henry M. Dawes: Chairman, board of directors. <sup>a</sup>	Director.....	Director.
Newton P. Frye: Director <sup>b</sup> .....		Vice president.
Carroll E. Gray, Jr.: Director <sup>b</sup> .....		Executive vice president.
Joseph E. Otis: Director.....	Director and chairman of board.	
Louis H. Schroeder: Vice president and director. <sup>b</sup>		Vice chairman of the board.
Eugene V. R. Thayer: Director.....	Director and chairman of the executive committee.	Chairman of the board.
Rawleigh Warner: Director <sup>b</sup> .....	Director.....	

<sup>a</sup> Id., at 1847-8. Three other members of the Dawes family were directly connected with the Central-Illinois group. W. R. Dawes was vice-president and a director of the bank. In 1932 he became president of the investment company and in 1935, chairman of its board. R. C. Dawes was also a director of the bank and of the security affiliate; and during 1930 and 1931 General Charles G. Dawes was honorary chairman and a director of the bank. On June 27, 1932, General Dawes, after resigning as a director of the Reconstruction Finance Corporation, became chairman of the board of directors of the Central Republic Bank and Trust Company, the successor of Central Trust Company of Illinois.

<sup>b</sup> Became a director of the security affiliate in 1931.

<sup>6</sup> Op. cit. supra, note 1, at 1925-8. Previous to his association with the Central-Illinois interests, Mr. Clarke had been president of the Federal Securities Corporation, an investment banking and underwriting organization. In June 1929, the bank purchased all the stock of the Federal Securities Corporation which thereupon was operated as a wholly owned subsidiary of the bank. In December 1929, Mr. Clarke became president of the bank, the security affiliate, and the investment company. (Id., at 1927-8.)

<sup>7</sup> Op. cit. supra, note 1, at 1988.

Subsequent difficulties of the investment company were in large measure ascribed by both Mr. Clarke and Mr. Dawes to this conflict of interests of the interlocking management.<sup>8</sup>

The extent to which Henry M. Dawes, chairman of the board of directors of the investment company for three years, supervised and participated in the activities of the investment company is indicated by his testimony:<sup>9</sup>

Q. Mr. Dawes, you attended the meetings of the Board fairly regularly, did you not?

A. Well, pretty regularly, yes. I was traveling a good deal.

\* \* \* \* \*

Q. Do you know anything about the Goudey Gum loan?

A. No.

Q. Do you know anything about the Utah Rock Asphalt Company loan?

\* \* \* \* \*

A. No.

Q. Do you know anything about the loans to the Utility Securities Company, which was an Insull company?

A. No.

Q. Do you know anything about approximately \$8,000,000 of loans which were made to Chicago brokers at various times?

A. No.

Q. Do you know anything about the purchase of the Personal Savings Bank stock?

A. No.

Q. Do you know anything about a loan on West Monroe Street property?

A. No.

Q. Of \$1,000,000?

A. No, I don't know anything about it.

Q. Do you know anything about the Western Continental Utilities, Incorporated?

A. Nothing of any importance, except I know it is a California utility, and that is about all.

Mr. Dawes amplified his testimony in regard to his position as director as follows:<sup>10</sup>

A. \* \* \* There is one problem I haven't any answer for, but I am just wondering, in thinking of my testimony or lack of it during the day here, and that is about directors.

Q. Yes?

A. I don't know what is right, and I was thinking, because I have probably appeared to you as a person who has neglected his obligations in this particular instance. I don't think I have. But here my time is occupied with these things. I have associates, friendly and otherwise, and contacts with the people in a bank, and I can't spare the time to go into the details of the things.

I get the best judgment I can of the general situation and wonder, after all, if I do bring anything to it. I certainly want to do that.

I wouldn't go into an association of that kind if I were assuming certain risks and certain responsibilities in connection with the thing, which would become moral responsibilities if incorporated into law.

\* \* \* \* \*

How you are going to protect that situation talking of the directors' liability, I don't know how to get at it.

Q. For instance, here is the name of Henry M. Dawes, Chairman of the Board.

A. Yes.

<sup>8</sup> Id., at 1985-94.

<sup>9</sup> Id., at 1921-3.

<sup>10</sup> Id., at 1994-6.

Q. And the person looking at the prospectus would have the right to assume that as Chairman of the Board you are fully familiar with every detail of the business?

A. Well, I presume that is so, that I shouldn't have allowed my name to be used as Chairman of the Board. But at the same time I never knew what a chairman of the board was \* \* \*.

Not only was the investment company entirely controlled by a board of directors completely interlocked with its sponsors, but, in addition, self-dealing transactions between the investment company and its directors and sponsors were explicitly authorized by the certificate of incorporation of the investment company. The charter provided:<sup>11</sup>

In case the Corporation enters into contracts or transacts business with one or more of its directors, or with any firm of which one or more of its directors are members, or with any other corporation or association of which one or more of its directors are stockholders, directors or officers, such contract or transaction shall not be invalidated or in any way affected by the fact that such director or directors have or may have interests therein which are or might be adverse to the interests of this Corporation; provided that such contract or transaction is entered into in good faith and authorized or ratified in the usual course of business as may be provided for in the bylaws of the Corporation.

It will be seen that this provision in the charter was not without significance; for, as will appear, a substantial and important part of the activities of the investment company came within the purview of the clause.

### C. Distribution of Investment Company's Stock

The initial public offering of securities of the investment company in October 1929, was in the form of units consisting of one share of convertible preference and one share of common stock, represented by allotment certificates which were convertible into stock of the investment company on or after November 1, 1931. The security affiliate offered 400,000 allotment certificates<sup>12</sup> at \$31.50 per certificate to the public. Of the total of \$12,600,000 received from the sale of these certificates the security affiliate paid to the investment company \$12,000,000, or \$30 per certificate, and retained \$600,000 or 5% as commission.

This issue, offered to the public two weeks before the stock market crash of October 1929, was oversubscribed in advance of the actual offering, and by the time the allotment certificates were publicly

<sup>11</sup> Reply to the Commission's questionnaire for Central-Illinois Securities Corporation, Pt. I (Exhibit A, Article Twelve).

<sup>12</sup> The certificate of incorporation of the investment company authorized the issuance of 1,000,000 shares of no-par convertible preference stock and 2,400,000 shares of no-par common stock. This authorization was changed by an amendment filed January 4, 1933, to 300,000 shares of no-par convertible preference stock and 1,300,000 shares of common stock of \$1.00 a share par value. The outstanding common stock was thereby converted into the new stock on a share-for-share basis. As a result of the repurchase of securities, the outstanding stock on December 31, 1935, consisted of 231,598 shares of preference stock and 909,787 shares of common stock.

The no-par convertible preference stock, entitled to cumulative dividends of \$1.50 annually, was callable at \$32.50 per share and entitled to \$27.50 per share on liquidation. It was convertible into common stock at any time on a share-for-share basis. Both classes of stock had one vote per share. (Op. cit. supra, note 1, at 1852-3, and Commission's Exhibit No. 329.)

offered, independent bids had established a price as high as \$42 per unit.<sup>13</sup> Mr. Frye, a director of the bank, the security affiliate, and the investment company, stated:<sup>14</sup>

\* \* \* the office was just deluged with people applying for the unit. I think that was quite normal, considering the period we were in.

At the time of the sale to the public of the 400,000 allotment certificates, the security affiliate purchased for its own account 600,000 shares of common stock of the investment company for \$3,000,000. The total capital, therefore, raised by the investment company was \$15,000,000.<sup>15</sup>

#### D. Method of Vesting Control of the Investment Company in the Security Affiliate

Despite a great disparity in price,<sup>16</sup> both the preferred and the common stock were equally entitled to one vote per share.<sup>17</sup> Consequently, the security affiliate by purchasing common stock alone, in return for a contribution of \$3,000,000, or 19% of the total sum contributed,<sup>18</sup> secured 600,000 votes, equal to 43% of the total voting power; while the public, purchasing in the form of units of both common and preferred stock, in return for a contribution of \$12,600,000, or 81% of the total sum contributed, obtained 800,000 votes, equal to 57% of the voting power.<sup>19</sup> By reason of the extensive distribution of the units<sup>20</sup> the security affiliate was assured of effective working control of the investment company, although lacking a majority of votes.

<sup>13</sup> Id., at 2127.

<sup>14</sup> Ibid.

<sup>15</sup> The following table summarizes the initial offering of the securities of the investment company:

Purchaser	Security	Number of shares	Cost to purchasers	Commission	Net proceeds to investment company
Public.....	Convertible preference <sup>a</sup> .....	400,000	\$12,600,000	\$600,000	\$12,000,000
	Common <sup>a</sup> .....	400,000			
Central-Illinois Co.	Common.....	600,000	3,000,000		3,000,000
		1,400,000	15,600,000	600,000	15,000,000

<sup>a</sup> Sold as unit allotment certificates consisting of one share of preferred and one share of common stock.

<sup>16</sup> The preferred stock was entitled to \$27.50 per share on liquidation. On the basis of the \$5 per share rate paid for the common by the security affiliate, the preferred would be valued at the time of issuance at \$26.50 per share.

<sup>17</sup> Op. cit. supra, note 1, Commission's Exhibits Nos. 236 and 239.

<sup>18</sup> The security affiliate's payment of \$3,000,000 equaled 20% on the sum of \$15,000,000 actually received by the investment company, but 19% on the \$15,600,000 paid by the purchasers.

<sup>19</sup> The public, required to purchase in the form of allotment certificates representing units of common and preferred stock, received the equivalent of 2 votes for each allotment certificate costing \$31.50, whereas the sponsor, purchasing common stock alone at the rate of \$5 per share, received the equivalent of 6½ votes for each \$31.50 invested.

<sup>20</sup> At the end of 1929 there were 5,200 holders of the investment company's allotment certificates, owning an average of 77 certificates each, which represented an average investment per holder of \$2,426. (Op. cit. supra, note 1, Commission's Exhibit No. 270.)

The possibility of upsetting the security affiliate's control of the investment company was rendered more remote by virtue of the fact that the allotment certificates were not exchangeable for the underlying shares until November 1931, a period of two years. During the intervening period, therefore, attempts to depose the security affiliate from control could be made only by purchases of the higher priced units.

Moreover, the charter provided that neither class of stock was to have any preemptive right to subscribe to new issues of stock.<sup>21</sup> The way was therefore open to the board of directors of the investment company to sell to the security affiliate all or any portion of the 1,400,000 shares of common stock and the 600,000 shares of preferred stock which had been authorized but not issued, at any time that the affiliate desired to increase its voting strength.<sup>22</sup>

### E. Activities of the Investment Company

As of December 31, 1935, the net loss, realized and unrealized, sustained by the investment company in its security transactions and loans amounted to \$7,315,000.<sup>23</sup> By far the greater part of the loss was suffered in transactions in which the investment company was

<sup>21</sup> Op. cit. supra, note 1, Commission's Exhibit No. 236. The certificate of incorporation states: "No holder of any stock of this Corporation shall be entitled as of right to purchase or subscribe for any part of any unissued stock of this corporation or for any additional stock of any class to be issued by reason of any increase of the authorized capital stock of this Corporation, or bonds, debentures, or other securities convertible into stock of this Corporation and any such unissued stock except that which has been reserved for the conversion of Convertible Preference Stock as herein provided or authorized issue of new stock or of securities convertible into stock may be issued and disposed of by the Board of Directors to such individuals, corporations, associations, or copartnerships upon such terms and for such considerations as the Board of Directors may determine." (Ibid.)

<sup>22</sup> Subsequent to 1931, the 600,000 shares of common stock initially purchased by the security affiliate were pledged as collateral security for a loan by the security affiliate with the Central Republic Bank and Trust Company, successor to the Central Trust Company of Illinois. The Central Republic Bank and Trust Company, in turn, pledged these shares with the Reconstruction Finance Corporation to secure a loan. For several years these shares were held by a nominee of the Reconstruction Finance Corporation, who, in June 1932, under the rights given in the agreement of pledge, voted the stock. (See infra.) By the end of 1935, as a result of purchases by the investment company of its own stock, the 600,000 shares represented 52% of the outstanding voting power of the investment company. Thus the Reconstruction Finance Corporation possessed a majority of the voting securities of the investment company at this time. However, the Reconstruction Finance Corporation made no attempt to exercise its rights to name the management, but merely required that it be accorded a representative on the board of directors. In the annual report to the stockholders of the investment company for the year of 1936, Walter L. Vincent, then president of the investment company, wrote: "On December 1st, 1936, 600,000 shares of our own Common Stock were purchased and are now carried in the treasury. This stock represented 52% of the voting rights of all stock outstanding and rested in the hands of the Receiver for the Central Republic Trust Company and the Reconstruction Finance Corporation. This purchase relieved the threat of acquisition of control by a purchaser or purchasers with interests which might have been adverse to the holders of the remaining outstanding shares of both classes of stock and insured the maintenance of control in the publicly owned stock." (Derived from supplementary information supplied the Commission for Central-Illinois Securities Corporation.)

<sup>23</sup> Op. cit. supra, note 1, Commission's Exhibit No. 270. An itemized analysis of this figure will be found in the summary of operations of the company, infra, p. 176 (Item 6).

placed because of its affiliated relationships.<sup>24</sup> These ventures were principally of two kinds: loans which the investment company was induced by the bank or security affiliate to make or which it purchased directly from them; and investments in the stocks of the bank or security affiliate or in the stocks of companies in which the bank and affiliate were in some manner interested.

The investment company commenced operations about October 21, 1929.<sup>25</sup> One week later, while its funds were still almost intact, the stock market broke precipitously.<sup>26</sup>

On November 13, 1929, the board of directors of the investment company, at its first business meeting,<sup>27</sup> and in the face of the collapsing securities market authorized acceptance of loan applications and offers of sale of various securities and notes receivable which were submitted on their own behalf by the bank, the security affiliate, and the bank's subsidiaries.<sup>28</sup> The sum of \$5,459,966, or about 36% of the investment company's resources, was advanced or pledged in these transactions.<sup>29</sup> In exchange for \$5,459,966 of cash, the investment company agreed to acquire from the bank and the security affiliate securities and obligations mainly of an unmarketable character. Consequently the funds of the investment company were utilized to increase the liquidity of the bank and the security affiliate at this time. Mr. Clarke, when examined as to the possible inference of an "unloading" of these securities and obligations by the bank and security affiliate on the investment company, testified:<sup>30</sup>

Q. I just wanted to point out something, Mr. Clarke. This was practically the first business meeting of the trust, November 13, 1929. The other meetings were just organization meetings.

A. That is it.

Q. Yet at the very first meeting there is a loan of \$1,000,000 secured by a lease to the sponsor, isn't that so? The trust loaned \$1,000,000 to its sponsor?

A. Yes, sir.

Q. At that very same meeting there was a loan of [\$500,000] to Central-Illinois Company, its sponsor, on the Goudey Gum as security?

A. Yes.

<sup>24</sup> Losses totaling \$6,826,729 were suffered by the investment in 4 groups of transactions which the investment company was caused to undertake by its affiliations (all these transactions are discussed in detail, infra):

Loss on loans taken over from sponsor-----	\$1, 112, 369
Loss on stock of the sponsor bank-----	2, 457, 917
Loss on stocks of banks in which sponsor was interested-----	1, 525, 752
Loss in Western Continental Utilities, Inc.-----	1, 730, 691
	<hr/> 6, 826, 729

<sup>25</sup> Op. cit. supra, note 1, Commission's Exhibit No. 240.

<sup>26</sup> Id., at 2045. Mr. Clarke referred to the period as "the debacle." (Ibid.)

<sup>27</sup> Op. cit. supra, note 1, at 2004-5.

<sup>28</sup> Id., Commission's Exhibit No. 248. The following transactions, many of which are hereafter discussed in detail, were authorized at this meeting:

With security affiliate—Purchase of Federal Securities Corporation note (secured by Goudey Gum Company stock)-----		\$500, 000
6,400 shares of Hickok Oil Preferred-----		576, 000
Loan secured by West Monroe Street Building-----		1, 000, 000
Loan for purchase of the investment company stock-----		1, 500, 000
With Federal Securities Corporation—Purchased the following:		
1,203 shares Congress Trust & Savings Bank stock-----		180, 450
250 shares National Builders Bank stock-----		62, 500
200 shares Drovers National Bank stock-----		75, 000
4,107 shares Personal Loan & Savings Bank stock, with unpaid assessments-----		1, 116, 016
Illinois Syndicate note-----		450, 000
Total-----		<hr/> 5, 459, 966

<sup>29</sup> Ibid.

<sup>30</sup> Id., at 2004.

Q. At the very same meeting there was purchased from the Central-Illinois Company 6,400 shares preferred capital stock of Hickok Oil Corporation for an aggregate of \$576,000?

A. As I say, I was not present, but I always had the impression that that was all purposely done in order to give this investment trust everything that the Central-Illinois Company had in its portfolio that might possibly not qualify for an investment house, in other words, not be subject to distribution in the normal course of its business and, at the same time, give this company the largest amount of earning assets at the earliest possible time.

Q. Well, I don't want you to think that I am inferring this, but all those deals, because of their specialized situation at the particular time they were made, namely, the half interest in a chewing gum company, and a million-dollar loan secured by a lease, and the purchase of the Hickok Oil stock for over a half million dollars, and then, which I will develop in more detail, the purchase of over a million dollars of bank stock from Central-Illinois Company, then the additional loan of \$1,500,000 in order for the securities company to maintain a stable market in this stock, all those factors might create in some [people's] minds \* \* \* an inference of [an] unloading, isn't that so?

A. Of a what?

Q. Of the sponsor unloading on its trust.

A. I wouldn't want to go so far as to say that. I think it certainly demonstrates that the Central-Illinois Securities was, of the three affiliated companies, the one to which long-term investments were to be turned over.

At subsequent meetings, additional transactions of like nature were authorized by the board of directors of the investment company. In effect, up to the time of the severance of the investment company from the successor of the bank in 1932, the investment company functioned as an auxiliary of the bank and its security affiliate,<sup>31</sup> taking over such existing investments as the sponsors did not think proper for themselves to retain or such financing proposals as they did not see fit to undertake but which they desired to have undertaken.

## 1. LOANS PURCHASED BY THE INVESTMENT COMPANY FROM THE BANK AND ITS AFFILIATES

On October 25, 1929, shortly after its organization, the investment company had approximately \$9,500,000 in the New York call loan market. Following the market break at the end of the same month, the bank and security affiliate determined to curtail the investment company's activities in the call loan market<sup>32</sup> and to direct them into a new channel. It was decided that<sup>33</sup>—

this trust, in an effort to give it the maximum current income, be permitted to take out of the bank's portfolio (The Central Trust Company of Illinois), or have the bank turn over to the trust, an amount of these well-secured, desirable brokers' loans or call loans.

Accordingly, the investment company purchased from the bank, over a period of time, loans to the amount of \$13,500,000.<sup>34</sup> Of this sum, \$9,000,000 went into the purchase of Chicago brokers' loans from the bank, which were apparently repaid. The balance of \$4,500,000 was used to acquire from the bank and its security affiliate loans made to affiliated interests or to enterprises in which affiliated interests were involved. On these purchases the investment company had sustained a net loss of \$1,112,369 as of December 31, 1935, and

<sup>31</sup> Id., at 2018.

<sup>32</sup> Id., at 2020.

<sup>33</sup> Id., at 2021.

<sup>34</sup> Id., at 2022.



a balance of \$195,666 remained unpaid<sup>35</sup> and was carried as an asset on the books of the investment company.

Several unusual practices characterized the transactions between the investment company and the bank. At the time of purchase of the various loans by the investment company from the bank, the latter retained the collateral deposited by the borrower as security for the loan and notified the investment company, from time to time, concerning changes in the status of the loan.<sup>36</sup> At times the bank retained some part of the loan for itself and sold only a participation in a loan to the investment company. Thereafter, from time to time, the bank sold the investment company additional participations in such loans and then made partial repurchases.<sup>37</sup>

A characteristic of most of the loans, excepting the loans to brokers, taken over by the investment company from the bank and its security affiliate, was their illiquidity. In large measure the same attribute characterized loans in which the investment company was induced to participate directly with the bank and its security affiliate.<sup>38</sup>

#### a. Utility Securities Company Loan—Loss \$215,572.33

From October 1929 to June 1931, the bank and subsequently its successor, Central Republic Trust Company, made aggregate loans in the sum of \$2,012,015 to the Utility Securities Company, a public utility investment company controlled by the Insull interests.<sup>39</sup> Commencing in May 1931 and continuing until July 23, 1931, the bank sold to the investment company participations in these loans to the extent of \$950,000, and made repurchases from it totaling \$450,000.<sup>40</sup>

<sup>35</sup> Id., Commission's Exhibit No. 251.

<sup>36</sup> Id., at 2022.

<sup>37</sup> Id., at 2025-6.

<sup>38</sup> However detrimental such participations may have been to the investment company, it is evident that they may not have been without advantage to the bank and the security affiliate, since these loans served to broaden contacts among brokers and investment bankers in Chicago, to procure potential sources of banking and underwriting business, and to strengthen relations with existing clients. For example, in connection with one loan to the Utility Securities Company, Philip R. Clarke, former president of the investment company and of the bank, testified that the Insull interests (controlling Utility Securities Company) were substantial depositors in the bank as they were in "all the downtown banks". (Id., at 2028.) The Insull interests were able to obtain several substantial loans from the bank.

<sup>39</sup> Id., at 2024.

<sup>40</sup> Id., at 2025. These transactions between the bank and the investment company in the loans to Utility Securities Company are as follows:

	<i>Purchases by investment company</i>	<i>Repurchases by bank</i>
May 20, 1931-----	\$100, 000	-----
May 21, 1931-----	150, 000	-----
June 22, 1931-----	-----	\$200, 000
June 23, 1931-----	200, 000	-----
June 26, 1931-----	150, 000	-----
June 30, 1931-----	-----	50, 000
July 2, 1931-----	200, 000	-----
July 22, 1931-----	-----	200, 000
July 23, 1931-----	150, 000	-----
Apr. 13, 1932-----	-----	<sup>a</sup> 275, 000
	950, 000	725, 000
	725, 000	
Balance unsold and unpaid-----	225, 000	

<sup>a</sup> Bank balance of Utility Securities Company applied on loan. Utility Securities Company defaulted on its obligation and subsequently went into receivership.



The loans made by the bank to the Utility Securities Company were secured by collateral but none of the collateral had been assigned or transferred to the investment company when it acquired its participations in the loan. Instead, the collateral deposited as security for the loan remained with the bank and was later turned over by its successor to the Reconstruction Finance Corporation as security for a loan. As of December 31, 1935, the books of the investment company showed a net loss on this transaction of \$215,572.33.<sup>41</sup>

b. Inland Investment Company Loan—Loss \$87,219.98

As in the case of the Utility Securities Company loan, the investment company purchased participations in a loan made by the bank in March 1930 to the Inland Investment Company, another Insull company,<sup>42</sup> portions of which participations were subsequently repurchased by the bank. The maximum participation of the investment company was \$850,000, which was ultimately reduced to \$99,500 by repurchases on the part of the bank. The Inland Investment Company went into receivership and the investment company recovered only \$12,280.02 on the loan thus sustaining a loss of \$87,219.98 in this venture.<sup>43</sup>

c. Repurchase Agreement Between Bank and Investment Company

Subsequent to the severance of the bank and the security affiliate from the investment company, a dispute arose with respect to the existence and enforceability of an agreement under which the bank undertook to repurchase upon demand the loans in which the investment company had participated. Recoupment of the losses suffered by the investment company on the Inland Investment Company and the Utility Securities Company loans, among others, was sought by the investment company from the Central Republic Trust Company, successor of the bank. The investment company's officers, who were at the time no longer connected with the bank,<sup>44</sup> claimed that the purchases

<sup>41</sup> Op. cit. supra, note 1, at 2027, and supplementary information supplied the Commission for Central-Illinois Securities Corporation. W. L. Vincent, now president of the investment company, stated that the Reconstruction Finance Corporation recognized that the investment company had a claim to a pro rata share of the collateral and that eventually this matter would be adjusted satisfactorily.

Mr. Clarke when examined on these participations, testified (op. cit. supra, note 1, at 2026-7) :

Q. Do you think, looking back \* \* \*, it is a proper transaction for a trust to participate in, where it becomes a minority participant in a substantial loan, where factually and practically it has no control over the disposition of that loan if any difficulty arises?

A. Well, I wouldn't want to condemn that practice. It is something that is more or less orthodox in commercial banking, in that many banks are given participations in loans that are controlled by large metropolitan banks.

Q. You are talking about commercial banks, but this was a financial institution that was sold to the public in the nature of an investment trust. Isn't that so?

A. I don't think that makes any difference. I wouldn't want to condemn the practice.

<sup>42</sup> The records of the investment company disclose that among the loans taken over by the investment company from the bank was one to a third Insull company, namely, the Middle West Utilities Company. This loan was in the sum of \$2,100,000 and, as far as is ascertainable, was repaid. (Op. cit. supra, note 1, at 2024.)

<sup>43</sup> Op. cit. supra, note 1, at 2029-30.

<sup>44</sup> See infra, note 46.

by the investment company of loans from the bank had been made on the oral but definite understanding at the inception of the arrangement, that such loans or participations would be taken up by the bank at any time upon request of the investment company.

The investment company's claim was embodied in the following letter<sup>45</sup> with the subscribed approval of nine former officers and members of the investment company's board of directors:<sup>46</sup>

DECEMBER 31, 1932.

Mr. WILLIAM C. FREEMAN,  
*Central Republic Trust Company,*  
*208 South La Salle Street,*  
*Chicago, Illinois.*

DEAR SIR: Central-Illinois Securities Corporation wrote to you under date of December 6, 1932, in connection with four loans owned by the Securities Corporation, which loans the Securities Corporation requested Central Republic Trust Company to take up pursuant to an agreement between the Trust Company and the Securities Corporation. This letter is being written to you to supplement the above letter and to acquaint you more fully with the agreement therein referred to.

The Board of Directors of the Securities Corporation approved purchases from the Trust Company from time to time of notes or participations in loans owned by the Trust Company upon the understanding of that Board, at the inception of the arrangement (the first purchase was October 31, 1929), as well as at all times afterward, that such loans or participations would be taken up by the Trust Company at any time upon request of the Securities Corporation. In the ordinary handling of the matter between the two companies, the obligation of the Trust Company to take up any loans was never required formally to be asserted, for, pursuant to reiterated statements at Board meetings of the arrangement between the Companies, whenever the Securities Corporation desired any loan to be repurchased a request to that effect was delivered by the Securities Corporation to the Trust Company, and, as will be observed from an examination of the schedule accompanying the letter of December 6th, any such loan or participation was taken up by the Trust Company.

Early in the year 1932 informal conversations were had between officers of the Securities Corporation and of the Trust Company, looking towards the taking up by the Trust Company of the remaining four loans presently in question, but because of conditions then existing action thereon was delayed at the request of the Trust Company. While the arrangement between the two Companies was never reduced to a formal document, it was the definite understanding of the Board of Directors of the Securities Corporation (the Board of the Securities Corporation included Mr. Philip R. Clarke, Mr. J. E. Otis, and subsequent to January 18, 1932, Mr. C. C. Haffner, Jr., all officers of the Trust Company; Mr. Haffner was the Treasurer of the Securities Corporation from its organization and prior to his election to its Board he, and Mr. W. W. Hinshaw, Jr., Secretary of the Securities Corporation and of the Trust Company, attended practically all meetings of the Board of the Securities Corporation) that such loans or participations as might be purchased by the Securities Corporation from the Trust Company would be subject to a repurchase obligation by the Trust Company. In view of the relationship of the parties a written commitment was deemed unnecessary, and the parties acted in accordance with the understanding as described.

<sup>45</sup> Op. cit. supra, note 1, Commission's Exhibit No. 254.

<sup>46</sup> At the time this letter was sent, the investment company was no longer affiliated with the bank. On October 5, 1932, Central Republic Bank and Trust Company ceased to function as a commercial bank, its deposits being assumed by City National Bank and Trust Company of Chicago. Philip R. Clarke, president, and General Charles G. Dawes, chairman of the board of directors of Central Republic Bank and Trust Company, resigned and became associated with City National Bank and Trust Company. In November 1932, a new board of directors was elected for the investment company and W. R. Dawes succeeded Philip R. Clarke as president of the company. Other details are given infra, pp. 174-5.

We understand that you have made a suggestion that you be furnished with affidavits, but we believe that your purpose will be fully served by the delivery to you of this letter.

A proposed exchange of securities and/or cash for present loans and participations purchased from the Trust Company and now held by the Securities Corporation, as outlined in the aforementioned letter of December 6, 1932, is under discussion. This letter is being written to you to induce you to make a final settlement of the matter between the Companies on the basis of the arrangement in existence between them.

Very truly yours,

CENTRAL-ILLINOIS SECURITIES CORPORATION,  
(Signed) By W. R. DAWES, *Pres.*

Approved.

(Signed) Rawleigh Warner, C. C. Haffner, Jr., Wm. H. Hinshaw, Jr., Philip R. Clarke, J. E. Otis, Louis H. Schroeder, Henry M. Dawes, W. R. Dawes, C. E. Gray, Jr., N. P. Frye.

Three months later, the Central Republic Trust Company rejected the investment company's claim in a letter dated March 21, 1933, signed by W. C. Freeman, vice president of Central Republic Trust Company, which stated in part:<sup>47</sup>

The Committee has given your claims careful attention, both in the light of the facts presented by you and such supplementary information as it has been able to obtain by independent investigation. On the basis of the evidence so far obtained or presented, the Committee is not fully convinced that the facts so far established are sufficient to justify the admission of any enforceable liability on the part of the Bank to repurchase the notes in question or to compromise the claim by an exchange of securities.

There is no disposition on the part of the Committee to be arbitrary, but of necessity, under present conditions, any claim must be established beyond doubt to entitle it to voluntary recognition.

That an agreement between the investment company and the bank, which involved \$13,500,000 in loans, should have been left merely oral in form can be explained only by the dual role that the interlocking directors were required to assume, as was stated in the letter from the investment company to the bank, set forth above:<sup>48</sup>

In view of the relationship of the parties a written commitment was deemed unnecessary \* \* \*.

Philip R. Clarke, former president of the two institutions, confirmed this view in his testimony:<sup>49</sup>

Q. Had the trust been independently sponsored you don't think that they would have left such a substantial, vital arrangement merely to this informal understanding?

A. I would say yes, but at the same time I think it is only fair to say that had the trust been independently sponsored they never would have been able to have gotten \$13,000,000 of loans as good as these loans were at the time they received them.

Q. What happened to the four loans could, of course, have happened to any one of the loans that went to make up the \$13,000,000?

A. There is always a hazard in every commercial loan.

Q. And they would have been confronted with the same probable liability of the trust company to repurchase these loans from the investment trust?

A. That is so. I referred to this yesterday. There is no question but what it is an embarrassing situation to those of us who were trying to function in two situations.

Q. And of course it came back—

A. It indicated just how clearly this dual relationship could bring about conflicting and embarrassing situations.

<sup>47</sup> Op. cit. supra, note 1, Commission's Exhibit No. 255.

<sup>48</sup> Id., Commission's Exhibit No. 254.

<sup>49</sup> Id., at 2037-8.

## d. The Federal Securities Corporation Loan—Loss \$300,000

Because of the relationship between the bank and the investment company, the investment company, in several instances, sustained substantial losses by reason of its failure to enforce its rights against the bank or its affiliates. For example, the security affiliate made a loan of \$500,000 to the Federal Securities Corporation, a subsidiary of the bank,<sup>50</sup> which was secured by 994 shares of stock (approximately 50% of the total outstanding shares) of the Goudey Gum Company, a small company engaged in the manufacture of chewing gum.<sup>51</sup> It was conceded that these shares had no market.<sup>52</sup>

On November 14, 1929, shortly after the stock market break, the security affiliate sold to the investment company this \$500,000 note of the Federal Securities Corporation, which was payable one year later and bore the indorsement of the security affiliate. The Federal Securities Corporation defaulted in payment of the note on its due date, November 14, 1930.<sup>53</sup>

The management of the investment company made no effort, after the default, to enforce the investment company's rights against either the security affiliate, indorser of the note, or the Federal Securities Corporation, the maker.<sup>54</sup>

Sometime after the default in the payment of the note, the entire assets of both the Federal Securities Corporation and the security affiliate were pledged to other creditors, so that the investment company apparently was left with recourse only to the collateral for any recovery.<sup>55</sup> While it was asserted that the collateral was of value and that the chewing-gum company was being operated on a profitable basis,<sup>56</sup> nevertheless, since the date of default, only \$19,833 was

<sup>50</sup> See *supra*, note 6.

<sup>51</sup> *Op. cit. supra*, note 1, at 1971.

<sup>52</sup> *Id.*, at 1974-5.

<sup>53</sup> *Id.*, at 1973-4.

<sup>54</sup> Questioned on the steps taken to enforce the liability of the maker and indorser, Philip R. Clarke testified (*id.*, at 1976-7, 1974-5) :

Q. You said the Central-Illinois Company is still alive?

A. Yes.

Q. And the Federal Securities Corporation is still alive?

A. Right. So far as I know, they are.

Q. Was payment ever demanded from these companies from 1929 to December 31, 1935, do you know?

A. I don't know whether it was or not; no.

\* \* \* Q. Why hasn't the trust gone after the Central-Illinois Company and the Federal Securities Corporation for payment of this note?

A. I don't know what efforts have been made to get after the Central-Illinois and the Federal Securities Corporation.

Q. What efforts did you make during 1930, 1931, and part of 1932, Mr. Clarke, to demand payment of this note of the Federal Securities Corporation or the Central-Illinois Company?

A. I can't recall.

\* \* \* Q. The officers and directors of the trust owed no duty to the Central-Illinois not to demand payment of the note from them, so far as the investment trust was concerned, isn't that so?

A. I don't think that they were at any time apprehensive about the goodness of the note at maturity, at the end of one year.

Q. The fact was there was a loan of one-half million dollars secured by this highly specialized situation, a one-half interest in a gum company. That gum company stock had no market, did it?

A. No market, but value.

<sup>55</sup> *Op. cit. supra*, note 1, at 1954.

<sup>56</sup> *Id.*, at 1976 and derived from supplementary information supplied the Commission for Central-Illinois Securities Corporation.

recovered on this loan. As at December 31, 1935,<sup>57</sup> the sum of \$300,000 had been written off as a loss and there still remained a book balance of approximately \$180,000.

e. Illinois Securities Syndicate Loan—Loss \$433,577.23

On October 25, 1929, the investment company took over from Federal Securities Corporation, the bank's subsidiary, a loan of \$450,000 which the latter had made to the Illinois Securities Syndicate.<sup>58</sup> The Illinois Securities Syndicate, organized in June 1929, was comprised of a number of "Syndicate Members," and was headed by a "Managing Committee" consisting of David E. Shanahan, Max Goldberg, and Frank L. Webb.<sup>59</sup> Among the syndicate's members was Eugene V. R. Thayer, then chairman of the executive committee of the bank and a director of the investment company.<sup>60</sup>

The syndicate members contributed a total of \$495,000 to the venture which had as its stated purpose:<sup>61</sup>

\* \* \* financing, operating, and developing the Illinois Securities Company<sup>62</sup> and its subsidiaries \* \* \* by the acquisition, holding, and disposal of stocks, bonds, and other securities of such companies, or the acquisition, holding, and disposal of stocks and/or securities of other corporations or companies.

In effect, the syndicate was a trading account or, as it was characterized, a "blind pool".<sup>63</sup> The management committee was vested with "sole discretion and management of the Syndicate," with unlimited power, to buy, sell, or borrow.<sup>64</sup> The syndicate agreement explicitly exculpated both the syndicate members and the syndicate managers from all personal liability beyond their initial contribution. The agreement stated:<sup>65</sup>

Neither the members of the Managing Committee nor the Syndicate Members shall be personally liable for any debt incurred or for any contract or undertaking made by the Managing Committee, as such, or by any agent or attorney acting on behalf of the Managing Committee. In every written contract or undertaking entered into by the Managing Committee reference shall be made to this agreement and such contract or undertaking shall provide that the person, firm, or corporation so contracting with the Managing Committee shall look only to the funds and property held by them under this agreement as security for the performance of said contract or undertaking and for the payment of any debt, damage, judgment, or decree, or of any money that may become due and payable in any way by reason of the execution of such contract or undertaking.

The greatest part of the syndicate's resources was used to purchase the stock of the bank, the Central Trust Company of Illinois.<sup>66</sup> In October 1929, the syndicate obtained a loan of \$450,000 from the bank's wholly owned subsidiary, the Federal Securities Corporation.

<sup>57</sup> Op. cit. supra, note 1, Commission's Exhibit No. 251.

<sup>58</sup> Id., at 1956 et seq.

<sup>59</sup> Id., Commission's Exhibit No. 246.

<sup>60</sup> Id., at 1965.

<sup>61</sup> Id., Commission's Exhibit No. 246.

<sup>62</sup> The Illinois Securities Company was organized for the purpose of buying and selling securities. All of its stock was owned by the Illinois Securities Syndicate. (Id., at 1966.)

<sup>63</sup> Op. cit. supra, note 1, at 1958.

<sup>64</sup> Id., Commission's Exhibit No. 246.

<sup>65</sup> Ibid.

<sup>66</sup> Id., at 1966, and derived from supplementary information furnished the Commission for Central-Illinois Securities Corporation.

The loan was evidenced by the syndicate's demand note, bearing interest at the rate of  $5\frac{1}{2}\%$ . Of the collateral deposited as security for payment of the note, more than 90% consisted of stock of the bank.<sup>67</sup>

Federal Securities Corporation sold this note to the investment company shortly before the market break of 1929. Concerning this purchase by the investment company, Philip R. Clarke, its former president, testified:<sup>68</sup>

Q. This in fact, Mr. Clarke, was nothing but a blind pool, wasn't it? They could buy and sell anything?

A. Yes.

Q. Speculate in any security or gamble in any security?

A. Apparently so.

Q. And yet this agreement specifically provided that the only recourse of any person loaning money to the syndicate was to look to any property that the syndicate owned as a syndicate? Isn't that so?

A. Yes.

Q. Yet the trust on October 25, 1929, when the rumblings of the stock market crash were already in the air, went and purchased this \$450,000 loan from the Federal Securities Corporation, which was an affiliated body? Isn't that so?

A. Yes.

Q. Now \* \* \*

A. As I said, undoubtedly at that time the market value of the collateral was in excess of the advance, the loan.

In effect, the purchase of the syndicate's note, without right of recourse against the syndicate members, constituted an arrangement by which the investment company assumed, for the usual interest charge, all the risks incident to the operation of a syndicate or trading account in the event of a declining market, while all the profit, if any, would accrue to the syndicate members.

On December 31, 1929, the investment company renewed the loan to the syndicate and continued to hold the bank stock as collateral. Ultimately the investment company sustained a loss of \$433,577 of the original loan of \$450,000 made to the Illinois Securities Syndicate.<sup>69</sup>

## 2. LOANS MADE DIRECTLY TO THE SECURITY AFFILIATE

In addition to the loans and securities which the investment company took over from the security affiliate, the bank and its subsidiary, the Federal Securities Corporation, the investment company made loans directly to the security affiliate to finance ventures in which the security affiliate was interested.

On November 13, 1929, shortly after the market break, at the first business meeting of the investment company's board of directors, the directors authorized a loan of \$1,000,000 by the investment company to the security affiliate for three years,<sup>70</sup> which was to be secured by an assignment of the security affiliate's interest in a leasehold to premises known as "125 West Monroe Street, Chicago," the former quarters of the bank.<sup>71</sup> While the agreement for the loan

<sup>67</sup> Id., at 1967.

<sup>68</sup> Id., at 1958-9.

<sup>69</sup> Id., at 1962.

<sup>70</sup> Id., Commission's Exhibit No. 248.

<sup>71</sup> Id., at 1999.

recited that as of November 13, 1929, the leasehold was valued at \$1,500,000, the cost to the security affiliate of the lease was \$1,050,000. For financing substantially the entire cost of the leasehold in a declining real estate market,<sup>72</sup> the investment company was to receive 25% of any profit eventually realized by the security affiliate on the sale of the lease, profit being defined as any sum in excess of the cost of the lease plus expenses.<sup>73</sup>

Approximately one year after this loan was made, the security affiliate, as a result of a reorganization plan for the building, acquired \$1,250,000 of debentures in exchange for its interest in the leasehold. These debentures were transferred to the investment company, in exchange for the promissory note of the security affiliate and the assignment of the lease. The investment company thus was left only with the debentures, without the obligation of the security affiliate for its \$1,000,000 loan.<sup>74</sup>

This exchange and release were apparently made solely to accommodate the security affiliate. The minutes of the investment company recite that in order to carry out the terms and provisions of the plan of reorganization, the security affiliate was desirous of securing the release of the lien which the investment company held upon the interest of the security affiliate in the leasehold, and had offered to exchange the debentures for the note and the assignment of the lease. The board of directors of the investment company thereupon voted to accept this offer and authorized the officers to make the exchange.<sup>75</sup> Four days before the merger of the bank and the National Bank of the Republic, the investment company turned back to the security affiliate the \$1,250,000 of debentures and received payment of \$1,000,000.<sup>76</sup> Immediately thereafter, the sum of \$800,000 was disbursed by the investment company in the purchase of stock of the National Bank of the Republic, a purchase which was admittedly effected to facilitate the merger of the two banks.<sup>77</sup>

### 3. LOANS MADE DIRECTLY TO SECURITY AFFILIATE FOR MARKET OPERATIONS IN INVESTMENT COMPANY'S STOCK

In connection with the original distribution of the units of preferred and common stock of the investment company by the security affiliate in October 1929, the stockholders of the bank had been circularized and offered the securities.<sup>78</sup> Approximately two weeks

<sup>72</sup> *Id.*, at 2001.

<sup>73</sup> *Id.*, Commission's Exhibit No. 248.

<sup>74</sup> *Id.*, at 2002-3 and Commission's Exhibit No. 249.

<sup>75</sup> *Ibid.*

<sup>76</sup> *Id.*, at 2004.

<sup>77</sup> For more detailed discussion of this purchase, see *infra*, pp. 162-3. Mr. Clarke, however, denied that the repayment of the 125 West Monroe St. loan was designed to enable the investment company to make the purchase of the stock of George Woodruff in the National Bank of the Republic so as to facilitate the merger of Central Trust Company of Illinois and National Bank of the Republic. (*Op. cit. supra*, note 1, at 2004.)

<sup>78</sup> Newton P. Frye, vice president of the security affiliate, testified (*id.*, at 2127): "We sold them as we normally sell any security issue, by circularizing our own list of customers, and it runs through my mind that we may have circularized the stockholders of the bank—certainly not the depositors, only if the depositor happened to be a customer."



later, the stock market broke and the market price of the investment company units rapidly declined. Manifestly, such immediate depreciation in the market value of the units of the investment company would not redound to the prestige and interest of the bank in view of the unrealized losses sustained by the stockholders of the bank who purchased the securities, and of the possible reflection on the managerial ability of the sponsoring bank. Apparently prompted by these considerations the investment company, following the market break, made substantial loans to the security affiliate to finance the security affiliate's market operations in the stock of the investment company.

The security affiliate commenced buying the stock of the investment company "in an endeavor to preserve an orderly market \* \* \* for the protection of the stockholders thereof \* \* \*." <sup>79</sup> On November 13, 1929, the chairman of the board of directors of the investment company reported to the board that the security affiliate had purchased \$1,400,000 of the stock of the investment company during the preceding two weeks. He further stated that, inasmuch as the security affiliate would be required to make additional purchases, "it was advisable and for the best interests of this corporation and its stockholders to cooperate with the Central-Illinois Company to the extent of making available to that Company funds from time to time required by it to maintain and continue such policy of market stabilization." <sup>80</sup>

Thereupon, the board of directors of the investment company voted to lend to the security affiliate up to \$1,500,000 "as may be required by that company to effect the purchase of units of Central-Illinois Securities Corporation stock from time to time offered on the market \* \* \*." <sup>81</sup> At the same time the president of the investment company was authorized to purchase its own stock "to such extent and in such manner as may be determined by the President of this corporation in his discretion \* \* \* at such prices as may from time to time be determined by the President of this corporation." <sup>82</sup>

Thus, approximately one month after the organization of the investment company, the security affiliate had repurchased on the market \$1,400,000 of the investment company's securities (or approximately 10% of the total contributed capital of the investment company) at substantial discounts below asset value <sup>83</sup> and in addition the sum of \$1,500,000 was made available by the investment company for further purchases. Only \$560,811 of this latter sum was actually borrowed by the security affiliate and was later repaid. <sup>84</sup> Although Mr. Clarke, president of both the investment company and the security affiliate, stated that the stock purchased on the market by the security affiliate was not resold to the investment company, <sup>85</sup> the records of the investment company disclosed that, during the year

<sup>79</sup> Op. cit. supra, note 1, Commission's Exhibit No. 248.

<sup>80</sup> Ibid.

<sup>81</sup> Ibid.

<sup>82</sup> Ibid.

<sup>83</sup> Id., at 2046, 2057-8.

<sup>84</sup> Id., at 2049-50.

<sup>85</sup> Id., at 2052.



1931, the investment company purchased for about \$1,000,000<sup>86</sup> approximately 40,000 units of its own stock from the security affiliate.<sup>87</sup>

#### 4. LOAN TO UTAH ROCK ASPHALT COMPANY

In 1930, the investment company made a direct loan of \$150,000 for one year to the Utah Rock Asphalt Company in which some of the officers and directors of the investment company were interested. This company, Mr. Clarke testified, was a "promotion" formed to develop some asphalt beds in Utah.<sup>88</sup> The note of the asphalt company was endorsed by 25 of its stockholders (among whom were Joseph E. Otis, chairman of the board of directors of the bank and director of the investment company, and Stuart Otis, secretary of the investment company), who jointly and severally guaranteed full payment of the obligation. Utah Rock Asphalt Company defaulted in payment of the note. By the end of 1935, the investment company had written off \$75,000 on this loan, had collected \$59,500 from the various endorsers and carried \$15,500 as an asset on its books.<sup>89</sup>

#### 5. SUMMARY OF INVESTMENT COMPANY'S LOANS

On these various loans, previously discussed, the investment company sustained a total loss, realized and unrealized, as of December 31, 1935, of \$1,111,369, and \$195,666 remained on the books of the investment company to be realized or further written down.<sup>90</sup> Viewing these loans in retrospect, Philip R. Clarke, former president of the investment company, testified:<sup>91</sup>

Q. \* \* \* looking back \* \* \* do you consider them proper investments?

A. Most emphatically not, looking back \* \* \* I think we have all learned a lot of lessons and I think very decidedly it is a mistake for an officer of a commercial bank to have any connection with an investment trust \* \* \*.

\* \* \* \* \*

Q. Put frankly and candidly, Mr. Clarke, that relationship necessarily creates a dual function, particularly in these instances where a trust is dealing either with a bank or with a security affiliate of the bank.

A. That is true.

Q. Every time the investment trust purchases one of the loans from the securities affiliates or purchases a loan from the bank, you are necessarily put in that position where you are acting on both sides of the transaction, isn't that so?

<sup>86</sup> Id., at 2052 et seq., and Commission's Exhibits Nos. 256-259.

<sup>87</sup> During the six-month period in which these 40,000 units were repurchased by the investment company from the security affiliate, there were traded on the Chicago Stock Exchange a total of approximately 50,000 units of the investment company's stock, which would make the investment company's purchases 80% of the total amount of stock traded (Id., at 2058-9). However, allowance must be made for the fact that some of this stock was doubtless accumulated by the security affiliate prior to January 1931, and consequently should not be included within the six-month period. Mr. Clarke stated that 50% of the total trading in these units on the exchange during this period was for the account of the investment company which had issued the stock. (Id., at 2059.)

<sup>88</sup> Op. cit. supra, note 1, at 1978.

<sup>89</sup> Id., at 1979, and Commission's Exhibit No. 251.

<sup>90</sup> Id., Commission's Exhibit No. 251.

<sup>91</sup> Id., at 1980-82.

A. A very difficult position, and it, of course, became more accentuated as soon as trouble began to ensue.

Q. Then it was necessary for individuals who are dominating both of them to make decisions which might sacrifice the interests of one or the other, both ways, isn't that so?

A. Exactly.

Q. You feel there is no useful purpose served by having a commercial bank acting as sponsor to an investment trust?

A. I feel that it is very illogical, based on the experience we have had.

Philip R. Clarke further testified:<sup>92</sup>

Q. You have emphasized the difficulties that you may have where a commercial bank is affiliated with these various interests and therefore at times may be called upon, particularly at times of distress, to make decisions as to who should take the substantial losses or who should be favored?

A. Right.

Q. Is that situation peculiar to sponsorship by commercial banks?

Do you feel you have that same situation where a private investment bank or banker is acting as the sponsor of an investment trust and is in a position to deal with the investment trust as principal?

I mean, is your analysis indigenous to commercial bank sponsorship, or do you have the feeling, based upon your experience and knowledge, that that situation can be duplicated where investment bankers or private bankers act as sponsors of the trust?

A. It probably doesn't apply to quite as great a degree in the relationship between the investment trust and the private banking house.

But, again, I want to say that personally I would not be a candidate for an officer in an investment trust if I had any other kind of financial affiliation whatsoever.

On the other hand, I know of one or two investment trusts that I think are being splendidly administrated that are allied with private banking houses.

Q. You feel that it is pretty hard to disassociate the personality when you are put in the position where you have got to deal on both sides of the bar—isn't that so?—which you are if you have interlocking directorates or interlocking officers. Isn't that so?

A. When trouble comes along.

Q. When everybody is making money, it is all right?

A. Yes.

Q. It is when they have to take the losses that you are in difficulty?

A. Yes.

## 6. LOSSES THROUGH INVESTMENTS IN THE BANK STOCK AND STOCK OF COMPANIES AFFILIATED WITH THE BANK

The experience of the investment company in connection with its loans made directly to or purchased from its sponsors and affiliates was repeated on a larger scale in the case of its investments in the stock of its sponsors and in other investments induced by them. These losses, realized and unrealized, totaled \$5,714,361.<sup>93</sup>

These losses were sustained by reason of (1) the purchase by the investment company of the securities of the bank and its successor; (2) the purchase from Federal Securities Corporation, the subsidiary of the bank, of the securities of various small outlying banks in a manner calculated to render the investment company a holding company for "branch bank" stocks; and (3) the participation of the investment company in Western Continental Utilities, Inc., for which the security affiliate was the investment banker.

<sup>92</sup> Id., at 1989-91.

<sup>93</sup> Id., Commission's Exhibits Nos. 251 and 268; see *infra*, pp. 162-174.

## 7. PURCHASE OF SECURITIES OF THE BANK ON A COLLAPSING MARKET—LOSS \$2,457,917

The largest single loss to the investment company, amounting to \$2,457,917, was suffered through its investment in the stock of the bank, the Central Trust Company of Illinois and in the stock of its successor,<sup>94</sup> Central Republic Bank and Trust Company. Prior to the merger in June 1931 of Central Trust Company of Illinois and the Chicago Trust Company to form Central Republic Bank and Trust Company,<sup>95</sup> the investment company had purchased stock of its sponsoring bank, Central Trust Company of Illinois, for approximately one-half million dollars.<sup>96</sup> By the time the successor bank was formed, this block of stock had depreciated in market value by approximately \$200,000.<sup>97</sup> Henry M. Dawes, former chairman of the investment company's board of directors, when examined on the accumulation of this block during the period, testified:<sup>98</sup>

Q. During the period from 1929 to January 21, 1931, were there any peculiar aspects with respect to the banking conditions in Chicago?

A. Between 1929 and 1931?

Q. Yes.

A. Yes; of course. Obviously, there were everywhere.

Q. That is, at least the first rumblings of possible disastrous conditions with respect to the banks were being heard during that period, isn't that so?

A. Yes.

Q. Yet, the trust on January 21, 1931, made an investment of \$278,003.21 in the capital stock of the Central Trust Company of Illinois.

A. I remember that time. That was when they had the large posters up saying prosperity was just around the corner.

On June 9, 1931, officers and directors of the investment company, in order to facilitate the merger of the banks, agreed to have the investment company purchase for \$800,000 a block of 20,000 shares of the National Bank of the Republic of Chicago (which had shortly before been merged with Chicago Trust Company) from George Woodruff, the president of the former bank.<sup>99</sup> The current market price of these shares was between \$500,000 and \$600,000.<sup>100</sup>

<sup>94</sup> See supra, note 2.

<sup>95</sup> Ibid.

<sup>96</sup> Op. cit. supra, note 1, Commission's Exhibit No. 243.

<sup>97</sup> Id., at 1872.

<sup>98</sup> Id., at 1860-1.

<sup>99</sup> Id., at 1865, 1937; and Commission's Exhibit No. 242. This stock was held by the Chicago Bank Stock Corporation, a personal holding company of Mr. Woodruff.

<sup>100</sup> Henry M. Dawes, chairman of the board of directors of the investment company, testified (id., at 1870-1):

Q. \$800,000 was paid for these 20,000 shares of National Bank of the Republic. That makes it at the rate of \$40 a share, does it not, Mr. Dawes?

A. Yes; I suppose that is correct.

Q. Do you know what the market price of National Bank of Republic stock was on June 9, 1931?

A. No; I do not. I think it was higher than that, but I don't know. I am just guessing on it. I have been guessing here before, and I will on that.

Q. Well, let me read you the price quotations of the National Bank of the Republic:

For December 1928, it was 247 to 250.

December 1929, it was 152 to 155.

December 1930, it was 69 to 71.

April 1931, it was 47 to 49.

Now, I will get you the precise quotation—on June 8, according to the New York Times quotation, the National Bank of the Republic was 30-32, and on June 15 it was 23¾-24½.

So that the market price at the time that the investment trust contracted to purchase \$800,000 worth, according to the quotations of the New York Times, was 30-32, and on June 15 it was 23¾-24½.

Therefore according to the quotations the trust had paid approximately 200 to 300 thousand dollars in excess of the market value of that stock at that time.

A. Well, I am not in a position to discuss that except in a very general way, and the mere market quotations on a small block of stock doesn't represent—it may be either more or less than you would be justified in paying for a larger block. I simply don't know. I just throw out that thought.

It was suggested by Mr. Woodruff,<sup>101</sup> but denied by Mr. Clarke,<sup>102</sup> that the premium was paid by Central Trust Company interests to eliminate him from any connection with the successor bank. Mr. Clarke and Mr. Dawes explained that, at the price, the stock "looked like an attractive investment."<sup>103</sup> However, at the time this purchase was made, banking conditions in Chicago concededly were far from inviting; in fact, they were highly precarious.<sup>104</sup> Neither the bank, the security affiliate, or the officers and directors of these institutions personally, were sufficiently persuaded by the attractiveness of this investment made by the investment company at from \$200,000 to \$300,000 above market price to make the purchase for their own account.<sup>105</sup>

On October 5, 1931, the block of 3,315 shares of the stock of the successor bank owned by the investment company<sup>106</sup> had a market value of about \$350,000, as compared with an original investment of approximately \$1,300,000.<sup>107</sup> Mr. Clarke testified that even before that time the condition of the successor bank had become a matter of concern.<sup>108</sup> By December 1931 the withdrawals of deposits were "very severe" and the market price of the bank's stock was falling "precipitately."<sup>109</sup> Nevertheless, between December 14, 1931, and June 1, 1932 the investment company bought in the open market additional stock of the successor bank to the extent of about \$400,000.<sup>110</sup> Admittedly, the investment company purchased the stock of

<sup>101</sup> Op. cit. supra, note 1, at 1894.

<sup>102</sup> Id., at 19345.

<sup>103</sup> Id., at 1934, 1869. The agreement of purchase between the investment company and the Chicago Bank Stock Corporation stated: "Whereas, an agreement \* \* \* for a union of the National Bank of the Republic, of Chicago, \* \* \* with Central Trust Company of Illinois \* \* \* has been entered into, and it is recognized in connection with the consummation of said union of said 2 bank groups there must be acquired not exceeding 20,000 shares of the capital stock of the National Bank of the Republic, of Chicago, \* \* \* Central-Illinois Securities Corporation has arranged to purchase \* \* \* said 20,000 shares of stock \* \* \* ." (Id., Commission's Exhibit No. 242.)

<sup>104</sup> Mr. Dawes testified (id. at 1863-4) that some 2 weeks before the merger of the 2 banks, the Foreman Bank in Chicago had closed (June 8, 1931); and immediately thereafter 13 other Chicago banks closed. It was at that time that negotiations were undertaken between the bank and the National Bank of the Republic, of Chicago. Mr. Dawes testified that the purpose of the merger was to strengthen public confidence as well as the financial condition of the 2 banks. (Ibid.)

<sup>105</sup> Op. cit. supra, note 1, at 1935-6. Mr. Clarke testified (id., at 1937-8):

Q. Was there any time you became convinced this buy was not as attractive as you thought it was at the time you bought it for the trust?

A. Yes; some six or eight months later.

Q. Some six or eight months later?

A. Yes.

Q. What convinced you of that fact?

A. The general banking conditions in Chicago and the overwhelming deposit withdrawal demand made upon the Central Republic Bank.

Q. That is, the merger did not have its contemplated effect, the withdrawal of deposits were still taking place?

A. That largely started after it was consummated.

<sup>106</sup> Following the merger, as of August 20, 1931, the investment company owned 1,133<sup>55</sup>/<sub>165</sub> shares of Central Republic Bank and Trust Company stock received in exchange for its Central Trust Company holdings and 2,182 shares of the new bank stock received for the 20,000 shares of National Bank of Republic stock, or 3,315<sup>55</sup>/<sub>165</sub> shares in all. (Op. cit. supra, note 1, Commission's Exhibit No. 243.)

<sup>107</sup> Id., at 1948.

<sup>108</sup> Id., at 1939.

<sup>109</sup> Id., at 1940 et seq.

<sup>110</sup> Id., Commission's Exhibit No. 243. Mr. Clarke testified that during part of the period the investment company was making purchases every day, in the face of very severe deposit withdrawals. (Id., at 1940.)

the bank to check, if possible, the violent decline <sup>111</sup> in the price of the bank stock. Philip R. Clarke testified:<sup>112</sup>

Q. Now, I have just a few questions I would like to have answered. Theoretically and actually the trust was supposed to be a separate and distinct entity from the bank? Isn't that so?

A. That is right.

Q. And the officers and directors of the trust were duty bound to exercise their investment judgment and their ability for the best interests of the trust and not for the interests of the bank? Isn't that so?

A. They tried to.

Q. And under no circumstances should the interests of the stockholders of the investment trust be subordinated to the interests of the stockholders of the bank? Isn't that so?

A. Yes.

Q. You, as the president, were conscious of your obligation to the stockholders of the trust?

A. Right.

Q. There is no equivocation about this? This investment trust went in there deliberately, at the instance of its officers and directors, to try to support the market in the bank stock?

A. To try to protect its large holding in the bank stock.

Q. But, in the first place, the only way it could do it was to try to support the price of the bank stock and thus possibly help its own position in the bank stock? Isn't that so?

The thing you asked the trust to do was to go in in a declining market and take the stock? Isn't that so?

A. It asked for the collaboration with certain of the large holders to create an orderly market, rather than one which might drop violently if there wasn't some supporting bid in there.

Q. And it entailed the trust going in in that market, with the conditions as they were, and deliberately buying with the prices scaling downwards?

A. Right.

As a result, on June 1, 1932, the investment company owned 8,142 shares of the successor bank stock at an original cost of \$1,749,133.73.<sup>113</sup>

By this time the condition of Central Republic Bank and Trust Company was such that it would have had to close its doors if the Reconstruction Finance Corporation had not, in the last week of June 1932, made to it loans aggregating \$40,000,000.<sup>114</sup> Despite this substantial assistance, Central Republic Bank and Trust Company

<sup>111</sup> Mr. Clarke stated (id., at 1943): "The banking troubles in Chicago became quite acute, as far as the large Loop institutions were concerned, in late November [1931], and about that time it developed that there was a very direct relationship between the price of the bank's shares and the rate of deposit decline. There were two or three days when the bank stock declined precipitately and, before the day was over, there would be lines in front of the paying windows, many of these withdrawers confessing that their withdrawals were predicated upon the fact that the bank stock was rapidly declining and they wanted to get their money out of it."

<sup>112</sup> Id., at 1944-6.

<sup>113</sup> Id., at 1879.

<sup>114</sup> See opinion of Wilkerson, J., in *Reconstruction Finance Corporation v. Central Republic Trust Company*, 17 F. Supp. 263 (1936) at p. 280. "As a result of the withdrawal of money by depositors and its inability to borrow from other banks on its collateral, defendant bank would have been obliged to close its doors shortly after June 25, 1932, if it had not been able to obtain the loan on its collateral which was made by plaintiff [Reconstruction Finance Corporation]. The losses in the conduct of the business of defendant bank and the withdrawal of deposits, increased during July, August, and September 1932; and the evidence clearly shows that if its deposit liabilities had not been transferred to another bank, defendant bank would have been obliged, within a short time, to close its doors and go into liquidation. The agreement for the assumption of depositors' liabilities became effective in the morning of October 6, 1932."

was forced to cease operating as a bank of deposit on October 5, 1932, and subsequently under the name of Central Republic Trust Company, it was placed in receivership.<sup>115</sup>

The investment company's entire investment in the stock of the bank, costing \$1,749,133, was lost with the exception of \$105,416 which it realized from a liquidation distribution of 8,142 shares of Central Republic Company, leaving a net loss of \$1,643,717.<sup>116</sup> In addition to losing its investment, the investment company had to set up a reserve of \$814,200 to provide for the double liability attaching to the bank stock under the Illinois laws,<sup>117</sup> which increased its loss to the sum of \$2,457,917, or 140% of the investment cost.<sup>118</sup> This sum does not include the \$433,577 which was lost on the Illinois Securities Syndicate loan, secured by the bank stock, as described previously.<sup>119</sup>

The representation by investment trusts on the boards of directors of their portfolio corporations has been frequently defended as a means of obtaining authentic first-hand information concerning the operations of these corporations for the protection of the investment company's security holdings. In the case of Central-Illinois Securities Corporation this representation proved to be a decided disadvantage. Philip R. Clarke was president of the bank, the security affiliate and the investment company and various other individuals were directors of all three. Yet the investment company was permitted to remain with an aggregate investment of \$1,749,133.73 in the stock of the bank which was rapidly approaching insolvency.<sup>120</sup> The investment company apparently could not be permitted to liquidate its position in the bank stock lest the market price of the bank stock be further depressed and the withdrawals of deposits increased. Despite the fact that Mr. Clarke and the other directors necessarily had inside information as to the condition of the bank, this information was not utilized to protect the investment company. Emphasizing "the absolutely incompatible relationship" which confronted the officers, Mr. Clarke testified:<sup>121</sup>

<sup>115</sup> Mr. Clarke stated (id., at 1943): "The banking troubles in Chicago became quite Accounts of Illinois appointed a receiver for the bank with authority to collect and conserve its assets. Prior to this time no steps had been taken with respect to the legal liquidation of the Central Republic Trust Company, but on November 21, 1934, the Auditor of Public Accounts of Illinois also filed a bill for its dissolution.

<sup>116</sup> Op. cit. supra, note 1, Commission's Exhibit No. 252.

<sup>117</sup> Constitution of the State of Illinois, Article 11, Section 6; Illinois Revised Statutes, 1935, Chapter 16½, Section 6, Smith-Hurd, III. Stats. Ann. Suit was brought by the Reconstruction Finance Corporation in the Federal District Court on behalf of itself and all other creditors of the bank to enforce the liability of stockholders under these laws. Judgment was granted for the plaintiff on November 7, 1936 (*Reconstruction Finance Corporation v. Central Republic Trust Co.*, 17 F. Supp. 263 (1936)). On appeal to the U. S. Circuit Court of Appeals, 7th Circuit, the decree of the district court was affirmed, February 20, 1939 (*sub nomine, Reconstruction Finance Corporation v. John A. McCormick et al.*); petition for rehearing denied April 1, 1939.

<sup>118</sup> Op. cit. supra, note 1, Commission's Exhibit No. 252. When these figures were cited to Henry M. Dawes, former chairman of the investment company's board of directors, he observed (id., at 1880): "I draw the very clear inference on that that it was a poor purchase."

<sup>119</sup> See supra, pp. 156-7.

<sup>120</sup> As has been stated in the preceding paragraph, \$814,200 additional had to be provided for the double liability attaching to the bank stock under the Illinois law.

<sup>121</sup> Op. cit. supra, note 1, at 2141-2.

Q. I just want to see if this is not another typical example in connection with the close relationship between a commercial bank and an investment trust, if the officers of the bank were also officers of the trust, isn't that so, some of them?

A. Some of them, yes.

Q. You were president of the trust, and also president of the bank?

A. Yes.

Q. Of course, you had knowledge that the bank was in a fairly precarious condition, isn't that so? As time went on it became apparent it couldn't go on, particularly immediately before the R. F. C. loan was made?

A. Not until two or three days before the R. F. C. loan was made.

Q. The ordinary investor who had a block of bank stock seeing that situation could have gotten out of that situation and avoided the double liability, isn't that so?

A. Well \* \* \*.

Q. Yet the trust did not do that because of its relationship with the bank. It had to stay there and hold onto that bank stock, isn't that so?

A. That is an added reason. I doubt very much whether a large holder could have gotten out of the stock at that time. You can very seldom get out of bank stocks in large blocks.

Q. Aren't all those incidents indicative that there may be situations where you had to subordinate the interest of one to the interest of the other?

A. I reiterate what I said before that I think it is an absolutely incompatible relationship.

## 8. PURCHASE BY INVESTMENT COMPANY OF STOCK OF SUCCESSOR BANK

These losses did not, however, end further investment by Central-Illinois Securities Corporation, the investment company, in stock of the bank. In September and October 1932, the investment company subscribed for or underwrote \$831,250 worth of stock (6,650 shares at \$125 per share), of the City National Bank and Trust Company of Chicago.<sup>122</sup> This bank was formed on October 5, 1932 to take over the deposits of the Central Republic Bank and Trust Company. The original subscription of the investment company in City National Bank and Trust Company stock was "not to exceed \$400,000."<sup>123</sup> Subsequently, however, the board was advised that subscriptions totaling \$300,000 had not been paid, and that an additional \$131,500 remained unsubscribed. The board thereupon voted to increase the investment company's commitment by \$431,250, thus bringing the investment company's total subscription to \$831,250.<sup>124</sup> Regarding this commitment Mr. Clarke testified:<sup>125</sup>

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<sup>122</sup> Charles G. Dawes was chairman of the board of directors and Philip R. Clarke was president of City National Bank and Trust Company. It was testified that General Dawes resigned from the Reconstruction Finance Corporation in June 1932, a few days before the Central Republic Bank and Trust Company obtained from the Reconstruction Finance Corporation a loan of \$40,000,000. Mr. Clarke stated that General Dawes knew nothing about the impending loan to the bank. (Id., at 1942.) General Dawes was made chairman of the board of directors of Central Republic Bank and Trust Company on June 27, 1932. Simultaneously with the organization of the City National Bank and Trust Company, on October 6, 1932, the Reconstruction Finance Corporation loaned to Central Republic Bank and Trust Company \$50,000,000 more, thus making its total loan to this institution \$90,000,000. This \$50,000,000 was immediately turned over to City National Bank and Trust Company by the Central Republic Bank and Trust Company, along with other assets, to provide for the latter's deposit liabilities which the City National Bank and Trust Company assumed.

<sup>123</sup> Op. cit. supra, note 1, at 1884, and Commission's Exhibit No. 244.

<sup>124</sup> Id., at 1886, and Commission's Exhibit No. 245.

<sup>125</sup> Id., at 1951-2.



Q. Now, how would you characterize the additional investment of approximately \$800,000 in the City National Bank stock? Was that an attractive investment, or was it a sort of a protection of interest?

A. I should say it was both, just as I have felt and the rest of the members of the Board felt, that all of these other purchases were attractive, and later on also a measure of self-protection to the investment the company already had in the bank.

Q. Well, initially, the trust had by resolution authorized an investment of only \$400,000 in that stock. Isn't that so? \* \* \*

A. Well, yes.

Q. And two of the participants did not go through with their commitment at that time. Isn't that so?

A. As I understand it; I wasn't with the company at that time. I think I had resigned.

\* \* \* \* \*

Q. The interests organizing the City National Bank and Trust Company were having a little difficulty raising the \$5,000,000?

A. Yes, indeed.

At the end of 1935, the investment company still held 6,017 shares of stock in the City National Bank and Trust Company, with a book value of \$752,125, which equaled in excess of 12% of the total resources (at book value) of the investment company.<sup>126</sup> At that date, however, the market value of the stock, based on the quoted bid price, had shrunk to approximately \$566,000.<sup>127</sup>

## 9. USE OF THE INVESTMENT COMPANY AS A HOLDING COMPANY FOR BANK STOCKS—LOSS \$1, 525, 752

At the end of 1929, the Central Trust Company of Illinois was interested in acquiring a substantial interest in small outlying banks in Chicago, Illinois, in anticipation of the introduction of "branch banking,"<sup>128</sup> and stock in other banks to establish a correspondent relationship.

More than \$2,000,000 of the investment company's funds was invested in the stocks of nine banks, not including the securities of Central Trust Company of Illinois and its successor, thus constituting the investment company in effect a holding company for the stocks of banks in which Central Trust Company of Illinois was interested. The investment company sustained a loss, realized and unrealized, of \$1,525,752 on stocks of these nine banks.<sup>129</sup> Philip R. Clarke testified:<sup>130</sup>

A. Again I don't know whether or not this is in order. I only have my own opinion as to these transactions. They took place before my connection with the company. But I think this represents the efforts upon the part of the Central

<sup>126</sup> As of December 31, 1932, total assets were valued on the books at \$6,260,070 (also the market value); as of December 31, 1935, the book value of the total assets amounted to \$6,053,925. (Id., Commission's Exhibit No. 269B.) The market value of total assets at the end of 1935 was \$6,409,656.

<sup>127</sup> As of December 31, 1935, the stock of City National Bank and Trust Company was quoted at \$94 bid and \$99 asked. (Bank and Quotation Record, Supplement to Commercial & Financial Chronicle, January 10, 1936, p. 106.)

<sup>128</sup> The Banking law of Illinois provides: "No bank shall establish or maintain more than one banking house \* \* \* and no bank shall establish or maintain in this State or any other State or county, any branch bank, nor shall it establish or maintain in this State any branch office or additional office or agency for the purpose of conducting any of its business". (Illinois Revised Statutes, 1935, Chapter 16a, Section 9.)

<sup>129</sup> Op. cit. supra, note 1, Commission's Exhibit No. 251.

<sup>130</sup> Id., at 2008-9.



Trust Company to do what was more or less fashionable in Chicago at that time, in anticipation of branch banking. The large Loop banks were going to the outlying banks and acquiring either through some larger source or picking up in the open market from time to time a sufficient ownership in those banks to establish a sort of correspondent relationship between the large downtown banks and the outlying banks.

I think Mr. J. E. Otis was responsible for these purchases over a period of time, and I haven't any doubt when this Central-Illinois Securities Corporation was formed that they turned over to the Central-Illinois Securities Corporation those stocks they had acquired at cost, and I think furthermore, it was the intention at that time to use the Central-Illinois Securities as a holding company for any desirable and attractive outlying bank stocks they could acquire.

Q. There was no disclosure, Mr. Clarke, in the prospectus that this was intended to be a bank holding company.

A. No. The prospectus described a rather broad charter and offered no prohibition against the company acquiring securities of this kind. I don't think it was the intention of this company to specialize in bank stock, but nevertheless they invested a large sum of money \* \* \* in these outlying banks. I think they chose pretty good banks.

Q. We will come to that in a moment, just how good they were.

A. Yes.

Q. The fact is, in order for the bank to have an interest in these outlying banks so that they could have that connection, that investment was turned over to the investment trust?

A. That is right.

The largest loss on these bank stocks was suffered by the investment company on the stock of the Personal Loan & Savings Bank, of Chicago, purchased for \$910,316.92 from Federal Securities Corporation, the wholly-owned subsidiary of Central Trust Company of Illinois.<sup>131</sup> The investment company was also required, upon taking over this stock, to pay \$205,700 additional on unpaid subscriptions,<sup>132</sup> making its total investment \$1,116,016.92. As of December 31, 1935, the sum of \$828,527 had been written off as a loss by the investment company, and there remained a ledger balance of \$227,938. After giving effect to unrealized market appreciation, the net loss at that date was \$563,625.<sup>133</sup>

As of December 31, 1935, the investment company also sustained an additional unrealized loss of \$319,875 on an investment of \$447,000, in 3,000 shares of stock of The Chase National Bank of the City of New York.

Of \$529,914 invested in the stock of the seven local Chicago banks, the net loss, realized and unrealized, amounted to \$642,252 as of December 31, 1935.<sup>134</sup> The loss was greater than the amount of the investment because provision had to be made for double statutory assessments on the seven bank stocks.<sup>135</sup> On the nine bank stocks the total loss was, as has been stated, \$1,525,752.

<sup>131</sup> See *supra*, note 6. This purchase was made by the board of directors of the investment company on November 13, 1929, the first business meeting of the investment company.

<sup>132</sup> The subscriptions stood in the name of individuals who were officers of the Central Trust Company of Illinois. It was stated by Mr. Clarke that they held the stock as nominees for the bank. (Op. cit. *supra*, note 1, at 2007-8.)

<sup>133</sup> *Id.*, Commission's Exhibit No. 251.

<sup>134</sup> *Ibid.* This sum represents the loss after giving effect to any appreciation in the stocks as of December 31, 1935.

<sup>135</sup> See discussion of Illinois law *supra*, note 128.

10. INVESTMENT IN WESTERN CONTINENTAL UTILITIES, INC., AND RELATED COMPANIES—  
LOSS \$1,730,691.40

On November 21, 1929, the security affiliate proposed that the investment company lend \$500,000 to Western Continental Utilities Inc., secured by bonds of that utility company,<sup>136</sup> which bonds had been underwritten the previous year by Federal Securities Corporation, the wholly-owned subsidiary of the bank.<sup>137</sup> Philip R. Clarke, formerly head of Federal Securities Corporation and later (December 1929) president of the bank and the investment company, acknowledged that this loan was undertaken by the investment company because of the relationship of the bank to the investment company.<sup>138</sup>

Q. So that it was in connection with the Central-Illinois Company acting in the capacity of banker for the Western Continental that the Central-Illinois made the suggestion to the trust that it loan to Western Continental \$500,000, is that it?

A. I think so.

Q. So that here was a situation, basically, where the Central-Illinois Company was maintaining its good will and its contact with this client by having the trust loan it \$500,000, although the loan was good, isn't that so?

A. Well, I think that could be equally interpreted as a desire on the part of the Central-Illinois Company to furnish the Central-Illinois Securities Corporation with a good loan.

Q. Yes, but I say the Central-Illinois Company did not see fit to make the loan itself, but asked the trust to make the loan.

A. Didn't see fit to make the loan?

Q. Yes.

A. That is right.

This loan was subsequently repaid, and the investment company thereupon undertook new and greater commitments in Western Continental Utilities, Inc.

Western Continental Utilities, Inc., was a utility holding company owning stocks of operating utility companies engaged in the electric, water, and telephone business in California and in Texas, developed and controlled by interests affiliated with Chester H. Loveland, who was described as "a successful operator located in California."<sup>139</sup> It was stated that Mr. Loveland was a close friend of Carol E. Gray, Jr., who was the vice president of the Federal Securities Corporation at the time Philip R. Clarke was president, and who subsequently became executive vice president of the security affiliate and a director of the investment company.<sup>140</sup>

On June 19, 1930, two contracts were entered into between the security affiliate and H. M. Byllesby & Co., Inc.,<sup>141</sup> as purchasers, and

<sup>136</sup> Op. cit. supra, note 1, at 2063, and Commission's Exhibit No. 260.

<sup>137</sup> Id., at 2061.

<sup>138</sup> Id., at 2065-6.

<sup>139</sup> Id., at 2061.

<sup>140</sup> Id., at 2061, 2071. Mr. Clarke testified: "He [Mr. Gray] handled the negotiations leading to the purchase of these securities. I mention that because it was from that contact that the connection with the Western Continental Utilities Company later carried on through into Central-Illinois Securities."

<sup>141</sup> H. M. Byllesby & Co., Inc., a Chicago investment-banking firm, sponsored the Standard Gas & Electric Company utility system. Prior to the joint undertaking with Central-Illinois Company in the Western Continental Utilities, Inc., venture, H. M. Byllesby had participated in many ventures with Federal Securities Corp. (Id., at 2068.)

the Loveland interests, as sellers. The first contract provided for the purchase of 55,000 shares (of a total of 100,000 shares) of the Class B common stock of Western Continental Utilities, Inc., the top holding company, and 12,000 shares (the entire issue) of the \$6 preferred stock of Western Utilities Corporation, a sub-holding and operating company, by the security affiliate and H. M. Byllesby & Co., Inc., for the sum of \$2,300,000.<sup>142</sup> The second contract obligated the purchasers to buy from the Loveland interests, on demand at any time before January 1, 1931, an additional 30,235 shares of Class B common stock of Western Continental Utilities, Inc., at \$25 per share for a total of \$755,875.<sup>143</sup> The contract also provided that the purchasers agreed and guaranteed that Western Continental Utilities, Inc., would buy within six months certain "lands which \* \* \* have been reserved or acquired \* \* \* for or in connection with the Upper Sweetwater Reservation" in San Diego, California, the price of which approximated \$340,000.<sup>144</sup>

Mr. Clarke testified that the agreement to purchase the additional 30,235 shares was supplemented by a "gentlemen's agreement" to the effect that the California interests would not make demand upon the security affiliate, Central-Illinois Company, and H. M. Byllesby & Co., Inc., to purchase these additional shares except in the event that the managerial activities and policies of H. M. Byllesby & Co., Inc., proved unsatisfactory to the California interests, and for no other reason.<sup>145</sup>

The commitments of the security affiliate and H. M. Byllesby & Co., Inc. under the two contracts were as follows:

Stock (Western Continental Utilities, Inc., & Western Utilities Corporation)-----	\$2,300,000
Liability on the "put" <sup>146</sup> (for purchase of additional shares)-----	755,875
Liability on guarantee of land to be purchased by Western Continental Utilities, Inc.-----	340,000
	<hr/>
	3,395,875

The security affiliate (actually, as will be shown later, the investment company) by reason of its 50% participation was therefore committed to the extent of \$1,697,938, which amounted to more than 10% of the investment company's original paid-in capital, and a considerably higher percentage of its reduced worth as of June 1930. Furthermore, in the event that H. M. Byllesby & Co., Inc., would be unable six months later to perform its obligation with respect to the land-purchase guarantee or with respect to the "put" of additional stock, the investment company alone would have been liable for the full amount of the addition joint commitment of \$1,095,875.<sup>147</sup>

<sup>142</sup> Id., Commission's Exhibit No. 262.

<sup>143</sup> Id., Commission's Exhibit No. 263.

<sup>144</sup> Id., at 2075.

<sup>145</sup> Id., at 2074-5.

<sup>146</sup> The option on the part of the Loveland interests to demand purchase of these shares was termed a "put" by reason of the fact that they had a right to tender or "put" the stock to the other parties, in which event the other parties would have to "take" it. (Id., at 2074.)

<sup>147</sup> Id., at 2078. In Illinois, by statutory enactment all joint obligations are made joint and several; that is, both obligors are liable together under the contract and in addition each obligor alone is liable for full performance. (Illinois Revised Statutes, 1935, Chapter 76, Section 3.)

That these commitments were made in a frozen situation, which was recognized as such by the parties, is disclosed by the contracts, which referred to "the size of their respective holdings and to the fact that there is no market for said Class B common stock and will be no market for blocks of stock in the respective amounts held by the said respective parties \* \* \*" <sup>148</sup> To this effect Mr. Clarke also testified: <sup>149</sup>

Q. Now, there was no market for this Western Continental Utilities?

A. No; I don't think so.

Q. So that the trust in making this commitment, in the amount of \$1,698,000, was making a commitment in a—well, shall we say—frozen situation, where if there was any desire on the part of the parties to get out of that investment, they would be in difficulty? Isn't that so? They would have to find somebody interested in that situation?

A. It was a long expectation of profit. There wasn't any prospect of realization in the very near future.

By successive agreements, the time for exercise of the "put" of additional stock by the Loveland interests was extended until December 31, 1932, and for purchase of the California water lands until December 15, 1931. <sup>150</sup> The last extension agreement provided that these lands would be conveyed by the Loveland interests to a corporation called Jamacha Holding Company, Ltd., all of whose stock was to be purchased for \$450,000 by Western Continental Utilities, Inc., within six months. <sup>151</sup> Thus, the price for the water lands was increased \$110,000 above the \$340,000 provided in the earlier contract. <sup>152</sup> Since Western Continental Utilities, Inc., did not have the funds to make this purchase, the investment company and H. M. Byllesby & Co., Inc., lent to it the necessary amount and took as security the stock of the Jamacha Holding Company, Ltd. Subsequently, this loan was defaulted and the investment company lost \$144,409 in realizing on the collateral. <sup>153</sup>

Some indication of the confusion attendant on the interrelationship of the investment company and its sponsors is demonstrated by one aspect of this transaction. Throughout the years 1930 and 1931 the name of the security affiliate exclusively appeared in the various agreements in association with H. M. Byllesby & Co., Inc. On February 11, 1932, however, the name of the investment company, for the first time, was inserted in the compromise agreement of that date. The preamble of this agreement recited: <sup>154</sup>

Whereas *Central-Illinois Company*, an Illinois Corporation, H. M. Byllesby and Company, a Delaware Corporation, and the Investment Company, heretofore on June 19, 1930, made and entered into a certain written agreement (Hereinafter called the "Original Agreement"); and

Whereas said Original Agreement was supplemented by two other agreements entered into by the *same* parties on December 30, 1930, and June 30, 1931, respectively; and

Whereas said *Central-Illinois Company* subsequent to the making of said Original and Supplemental Agreements transferred all of its rights and obligations thereunder to the Central-[Illinois Securities] Corporation, and by reason thereof is no longer interested therein; \* \* \*

<sup>148</sup> Op. cit. supra, note 1, Commission's Exhibit No. 263.

<sup>149</sup> Id., at 2079.

<sup>150</sup> Id., at 2082, and Commission's Exhibit No. 264.

<sup>151</sup> Id., Commission's Exhibit No. 264.

<sup>152</sup> See supra, p. 170.

<sup>153</sup> Op. cit. supra, note 1, Commission's Exhibit No. 267.

<sup>154</sup> Id., Commission's Exhibit No. 265. Italics supplied.

Despite the fact that the investment company had from the outset furnished all the funds required by the various contracts<sup>155</sup> its minutes were silent concerning the Western Continental Utilities, Inc. venture for approximately 14 months after the original contracts were entered into.<sup>156</sup> Finally, after this period, on August 4, 1931, the minutes recited:<sup>157</sup>

Whereas said Central-Illinois Company in executing and carrying out the agreements mentioned above has at all times been acting as the Agent of, and for and on behalf of this corporation, and now being in the process of liquidation has requested this corporation to formally assume its remaining obligations thereunder, \* \* \*

At the time that the investment company was for the first time named as beneficial owner, the utility company was already in difficulties, and not long afterwards was placed in receivership.<sup>158</sup>

The minutes of the investment company, its books of account and supporting contracts constituted at the least a confused record, or as Mr. Clarke described it:<sup>159</sup>

It is a poor record, there isn't any question about that. \* \* \* The only thing I can think of is that it was simply a case of carelessness on the part of the lawyers or on the part of whoever executed the contract.

In the annual report to the stockholders of the investment company for the year 1930, under the date of January 12, 1931, Philip R. Clarke, president, wrote:<sup>160</sup>

As a result of its close affiliation with these institutions [Central Trust Company of Illinois and Central-Illinois Company] several opportunities have been developed during the past year that have enabled the acquisition on an attractive basis of substantial equities in companies whose future growth and expanding earning power offer the expectation of considerably increased value for such holdings.

Mr. Clarke admitted that the Western Continental Utilities, Inc., venture was one of the "opportunities" to which he referred.<sup>161</sup>

However, despite the "expectation of considerably increased value for such holdings" of which the letter spoke, two weeks earlier the Loveland interests had attempted to exercise the "put" and had been persuaded only with great difficulty to delay for six months longer. Mr. Clarke stated:<sup>162</sup>

\* \* \* here we were in a period when earnings were falling off, the result of the depression being more severely felt, and it therefore looked as if this "put" was being exercised [by the Loveland interests] on merely a cold-blooded basis, that the stock had become worth less than the amount of the "put" \* \* \*.<sup>163</sup>

<sup>155</sup> Id., at 2097.

<sup>156</sup> Ibid.

<sup>157</sup> Id., Commission's Exhibit No. 266.

<sup>158</sup> Id., at 2099-2100. Subsequent to the public hearings before this Commission, a copy of a letter dated June 23, 1930, sent by the Central-Illinois Company (the security affiliate) to the Central-Illinois Securities Corporation was forwarded to the Commission. In this letter it was stated that the Central-Illinois Company as "agent" had entered into the contract of June 19, 1930, on behalf of the investment company.

<sup>159</sup> Op. cit. supra, note 1, at 2095, 2120.

<sup>160</sup> Id., at 2080 and Commission's Exhibit No. 269-A.

<sup>161</sup> Id., at 2080.

<sup>162</sup> Id., at 2084-5.

<sup>163</sup> The "put" agreement was finally compromised on February 11, 1932 by the purchase on the part of H. M. Byllesby & Co., Inc., and the Central-Illinois Securities Corporation of 15,932½ shares in full discharge of the obligation (formerly 31,865 shares) at a price of \$28.50 per share instead of the \$25 price originally provided. Thus, the investment company invested an additional \$227,038 as its half share on the "put". (Id., at 2099 and Commission's Exhibit No. 265.)

The letter of Mr. Clarke to the stockholders of Central-Illinois Securities Corporation, while it may not have overstated the ultimate hopes of the management,<sup>164</sup> obviously afforded little assistance to the stockholders in formulating a sound appraisal of the Western Continental Utilities, Inc. situation as it existed at that time. Questioned on this point, Mr. Clarke replied:<sup>165</sup>

Certainly the situation wasn't as attractive as when the company first entered it, but I don't think there was any definite assurance that the company wouldn't survive.

Despite an increasingly unfavorable outlook, the directors of the investment company continued to invest additional sums in the sinking Western Continental Utilities, Inc. venture.<sup>166</sup> Beginning in November 1930 and continuing until December 1, 1932, the investment company made a series of loans to Western Continental Utilities, Inc., amounting in all to \$1,504,399, secured by the stock of operating companies controlled by Western Continental Utilities, Inc.<sup>167</sup> In July 1931, the investment company also purchased from Western Continental Utilities, Inc., a series of notes for a total of \$195,000.<sup>168</sup> In September 1931, the investment company purchased from Western Continental Utilities, Inc., \$331,550 principal amount Western Continental Utilities, Inc. Conv. 6's 1934 for a total of \$305,683.<sup>169</sup> The total loans made by the investment company to Western Continental Utilities, Inc., together with purchases of securities of that company and its affiliates<sup>170</sup> amounted to \$3,770,965.89<sup>171</sup>

In November 1932, Western Continental Utilities, Inc., went into receivership, preceded and followed by many of its subsidiaries and operating companies.<sup>172</sup>

As of December 31, 1932, Central-Illinois Securities Corporation had charged off on its books a loss on this venture of \$1,730,691.<sup>173</sup> The sum of \$1,609,399 was recovered through sale of securities and part payments of loans, and at the end of 1935, the investment company still carried \$430,875 of these loans and purchases as an asset on its books.<sup>174</sup>

Investments and loans made by the investment company in the Western Continental Utilities, Inc. venture totaled \$3,770,965, or ap-

<sup>164</sup> Id., at 2086.

<sup>165</sup> Id., at 2085.

<sup>166</sup> Early in 1930, Central-Illinois Securities Corporation purchased 1,455 shares of preferred stock of the Southwestern State Telephone Company, a subsidiary of Western Continental Utilities, Inc., for \$109,124.90. (Id., at 2101 and Commission's Exhibit No. 268.)

<sup>167</sup> Id., at 2102 and Commission's Exhibit No. 268.

<sup>168</sup> Id., at 2103 and Commission's Exhibit No. 268.

<sup>169</sup> Id., at 2103. At the public examination on Central-Illinois Securities Corporation, it was testified that this purchase was made by the investment company from Central Republic Bank and Trust Company. Subsequently, under date of September 29, 1936, Walter L. Vincent wrote to the Commission that the company's records were in error in this regard, and that the purchase had actually been made from Western Continental Utilities, Inc.

<sup>170</sup> See note 166 and *supra*.

<sup>171</sup> Ibid. and Commission's Exhibit No. 268.

<sup>172</sup> Id., at 2099.

<sup>173</sup> Id., at 2108-9 and Commission's Exhibit No. 268.

<sup>174</sup> Ibid. Walter L. Vincent, now president of the Central-Illinois Securities Corporation, testifying concerning the investment company's chances of realizing on its book balance, stated that there was even a possibility that the investment company would recover something on the "write-down" over and above the book balance. (Id., at 2137-8.)

proximately 25% of the investment company's original paid-in capital of \$15,000,000; but at the time these investments were made, the investment company's assets were considerably less, so that the percentage of its assets in this one undertaking far exceeded 25%.<sup>175</sup> The investment in Western Continental Utilities, Inc., plus the commitments in the various bank stocks, discussed above,<sup>176</sup> totaled \$8,444,281, or over half the original contributed capital of the investment company.<sup>177</sup> Mr. Clarke testified:<sup>178</sup>

Q. Can't we draw some lessons from this? The only reason you kept pouring this money in is because in the first instance you had a substantial investment in it?

A. Yes, indeed, I think you can draw a lesson from it.

Q. What lesson do you draw from it? Don't you always subject a trust to a situation like that when you disregard the element of diversification and put it substantially in one security where, as soon as the investment shows any inclination to be jeopardized, the tendency is to pour more money into that investment?

A. That is right.

Q. And by the time you are through, you are in for \$4,000,000, when you intended only to be in for \$1,000,000.

A. Yes. Put it the other way, if the company had stopped when it had acquired this B common stock, then it would have been wiped out without any participation in the reorganization, because the reorganization did not give anything in lieu of that common stock. The investment became altogether too large for a trust of this size, to have as an investment, but at the same time in explanation of why the action was taken, it was something where additional dollars were poured in to protect dollars that already had been invested.

Q. Don't you regard, or do you—I don't know—as one of the aspects of an investment trust the element of diversification?

A. I would say I do today very much more than I did five or six years ago \* \* \*.

If I was running an investment trust today I would never care to attempt to increase the value of that trust by as large an investment as this in a single enterprise.

Q. When you consider, Mr. Clarke, that they had approximately \$4,000,000 in the utility situation, when you consider they had approximately \$2,000,000 exclusive of the double liability of \$800,000 in the bank stock, you have got practically half the total assets of your corporation in two situations, haven't you?

A. Yes.

Q. Besides, when you consider the over \$1,000,000 that was put into the Personal Loan and Savings, the Drovers National, then the bank stock and the public utility stock was away over 50% of the total assets of that company?

A. Right.

## F. Management Record

The original board of directors of the investment company and the original staff of executive officers, as has been shown, were com-

<sup>175</sup> Id., at 2109.

<sup>176</sup> See supra, pp. 169-73.

<sup>177</sup> Op. cit. supra, note 1, at 2113-4. These investments were as follows:

Stock of Central Trust Co. of Illinois and Central Republic Bank and Trust Co.	\$1,749,133
Stock of City National Bank and Trust Co.	831,250
Stock of Chase National Bank	447,000
Stock of Personal Loan and Savings Bank	1,116,017
Stock of seven local banks	529,915
	<hr/>
Investment in Western Continental Utilities, Inc.	4,673,315
	3,770,966
	<hr/>
Total	8,444,281
Not included in the above computation is \$969,000 of reserves required on account of double liability assessments on the bank-stock (discussed supra).	

<sup>178</sup> Id., at 2111-3.



pletely interlocked with the management of the bank and the security affiliate and remained in office without significant change until November 1932. At that time the Central Republic Bank and Trust Company, successor to the Central Trust Company of Illinois, ceased to be a bank of deposit and thereafter confined itself to a trust business under the name of Central Republic Trust Company.<sup>179</sup> The deposits of the Central Republic Bank and Trust Company were taken over by the City National Bank and Trust Company of Chicago of which Philip R. Clarke became president.<sup>180</sup>

Until this time, November 1932, direction of the investment company's affairs was exclusively in the hands of its directors and officers. In December 1932, however, the investment company entered into a management contract with the Central Republic Company, security affiliate of Central Republic Bank and Trust Company. By the terms of this contract<sup>181</sup> Central Republic Company undertook to furnish to the investment company complete financial advisory service in connection with the "purchase, sale, exchange, or retention of securities, participations in underwritings or syndicates, and generally in connection with the investment and reinvestment of its funds." In addition, the investment company was furnished with office space, clerical help, and the service of a secretary. For these services, the investment company paid the Central Republic Company \$27,000 per year, plus expenses of special investigations. In January 1934, the contract was amended to provide a purely advisory service for which the Central Republic Company was paid \$16,500 annually. This contract was canceled in July 1935 at the time Walter L. Vincent became president of the investment company and thereafter the company operated without any management contract.<sup>182</sup>

Despite the fact that the original offering circular of the investment company stated prominently that there were no management contracts of any kind,<sup>183</sup> the stockholders were not notified when the investment company did enter into a management contract in 1932, whereby \$27,000 per year was to be paid to Central Republic Company, nor when this contract was amended in 1934; and none of the annual reports to the stockholders disclosed the existence of a management contract.<sup>184</sup>

<sup>179</sup> See *supra*, note 2.

<sup>180</sup> At the time this change in the character of the Central Republic Bank and Trust Company was made, William R. Dawes, its vice president, resigned, and, succeeding Phillip R. Clarke, became president of the Central-Illinois Securities Corporation in November 1932. In 1935, when Walter L. Vincent became president of the investment company, William R. Dawes became chairman of the board of directors. Various other of the directors and officers of the Central Republic Bank and Trust Company changed over to the Central-Illinois Securities Corporation about the same time as Mr. Dawes, in November 1932. Among them were Howard S. Camp and Curtis B. Woolfolk, who became treasurer and secretary, respectively, of the Central-Illinois Securities Corporation. (Id., Commission's Exhibit No. 269-G.)

<sup>181</sup> Id., Commission's Exhibit No. 269-A (Exhibit D, Part I).

<sup>182</sup> Derived from supplementary information supplied the Commission for Central-Illinois Securities Corporation.

<sup>183</sup> *Op. cit.* *supra*, note 1, Commission's Exhibit No. 239.

<sup>184</sup> It was claimed that this information was orally communicated to the stockholders who attended the stockholders' meetings. (Reply to the Commission's questionnaire for Central-Illinois Securities Corporation, Item 23.)



A summary of the result of the operations of the investment company from its organization in 1929 until December 31, 1935, is as follows:<sup>185</sup>

(1) Receipts (accrued):			
Net proceeds from sale of stock-----	\$15,000,000		
Total ordinary income-----	2,774,000		
Total-----			\$17,774,000
(2) Disbursements (accrued):			
Cost of operation:			
Operating expenses-----	\$423,000		
Income tax-----	98,000		
		\$521,000	
Returned to investors:			
Cash dividends paid-----	2,075,000		
Cost of repurchased stock-----	2,666,000		
		4,741,000	
Total disbursements-----			5,262,000
(3) Receipts less disbursements or net capital investment in corporation as of Dec. 31, 1935-----			12,512,000
(4) Net assets, securities at market, Dec. 31, 1935-----			5,197,000
(5) Net realized and unrealized loss-----			7,315,000
(6) The net loss is accounted for as follows:			
Loss from—			
Write-offs of loans-----	\$1,140,700		
Write-downs of investments--	5,834,600		
Realized losses from sale of securities-----	234,800		
Payments on stock of closed banks-----	120,000		
Provision for reserve for possible liability through ownership of stocks of closed banks-----	874,100		
Provision for reserve for losses on loans receivable--	140,800		
Provision for reserve for other losses and sundries-----	62,500		
Total-----		\$8,407,500	
Less gain from:			
Realized profits from sale of securities-----	\$574,600		
Recoveries on write-offs of loans and payments on bank stocks-----	162,900		
Unrealized appreciation Dec. 31, 1935-----	355,000		
Total-----		1,092,500	
Net realized and unrealized losses-----			7,315,000

The net asset position of the corporation at year-ends, based on market values where available, is shown in the following table:<sup>186</sup>

<sup>185</sup> Op. cit. supra, note 1, Commission's Exhibit No. 270, pp. 11-12.

<sup>186</sup> Derived from the reply to the Commission's questionnaire and supplementary information supplied for Central-Illinois Securities Corporation.

*Net assets at year-ends*<sup>187</sup>

1929-----	\$15,143,000	1933-----	\$4,415,000
1930-----	14,372,000	1934-----	4,504,000
1931-----	9,967,000	1935-----	5,197,000
1932-----	5,201,000		

Up to December 31, 1935, the investment company had paid no dividends on the common stock, but had paid on the preference stock \$1.56 per share in 1930; \$1.50 per share in 1931 and in 1932; and sixty cents per share in each of the years 1933, 1934, and 1935. For the entire period the dividends paid and declared amounted to \$2,073,300, while the total ordinary net earnings were \$2,400,600.<sup>188</sup> However, in computing ordinary income no allowance was made by the investment company for write-offs on loans or investments, payments, and reserves arising from statutory assessment liability on closed banks, and other items.<sup>189</sup> Because these losses were charged against capital account, a recapitalization was effected in 1932. The preferred stock was reduced from a stated value of \$25 to \$10 per share and the common stock was reduced from \$5 to \$1 per share. In this way a capital surplus of \$8,145,934 was created against which \$7,509,277 was charged, representing realized and unrealized losses on loans and investments as of December 31, 1932, and reserves for contingencies.<sup>190</sup>

As a result of repurchases of allotment certificates by the investment company and the payment of dividends and receipts of ordinary income, the amount of funds invested, originally \$15,000,000 in October 1929, diminished to \$12,512,000 on December 31, 1935.<sup>191</sup> Therefore, the depreciation of assets, amounting to \$7,315,000, represented a decline of 48.9% of the original investment and 58.5% of the reduced investment on December 31, 1935.<sup>192</sup>

The former officers of the investment company denied that the judgment of the interlocking directors was affected by a desire or intent to favor their other affiliations at the expense of the investment company.<sup>193</sup> For example, Philip R. Clarke, former president of the three interrelated companies, when examined upon the possible influence of the prospect of banking business for the bank and underwriting for the security affiliate, through the decision of the interlocking directors to have the investment company undertake the Western Continental Utilities, Inc., venture, testified:<sup>194</sup>

Q. You say "supplement the facilities." Hasn't it been your experience—again looking back \* \* \* that when you have a relationship like that between a commercial bank and an investment trust, or even a private bank and investment banking, that the sponsor of the trust, in order to obtain certain emoluments or advantages or considerations or good-will, although not

<sup>187</sup> At the end of 1938, the investment company's report to stockholders showed net assets, at market, of \$3,479,000. However, the company at this year-end held in its treasury 606,024 shares of its own common stock of which 600,000 shares were purchased in 1936 from the Reconstruction Finance Corporation (see note 16, *supra*) at a cost of approximately \$1,475,000. (Derived from supplementary information supplied the Commission for Central-Illinois Securities Corporation.)

<sup>188</sup> *Op. cit.* *supra*, note 1, Commission's Exhibit No. 270.

<sup>189</sup> *Ibid.*

<sup>190</sup> *Id.*, Commission's Exhibit No. 269-A. (Report of the Corporation for the year 1932.)

<sup>191</sup> *Id.*, Commission's Exhibit No. 270.

<sup>192</sup> *Ibid.*

<sup>193</sup> *Id.*, at 2117-S.

<sup>194</sup> *Ibid.*

having the feeling that a particular investment may be a bad one, or even feel that it is good, would put the trust in that situation, because as the result of the trust being so interested, the sponsor could gain these intangible benefits? Let us take the situation of the Western Continental Utilities, Inc. By virtue of the fact that the trust had a substantial interest in the Western Continental Utilities, the Central-Illinois Company hoped to get the financing of it?

A. That is right.

Q. Now, if the Central-Illinois Company didn't hope to get the financing it might have thought a little more carefully as to whether it was going to put the trust in there or if it was going to put its own money in. Isn't that so?

A. I wouldn't want to acknowledge that.

Q. No, but, of course, you can see the point I make is that the sponsor, being in the position where they control the funds of the trust, might well be subconsciously induced to make an investment on behalf of the investment trust, because there would be the intangible benefits accruing to the sponsors. Now, the fact is that the Central-Illinois Company hoped to get the financing. Is not that so? You say that was its only interest in the matter.

A. They had the financing, of course, before the Central-Illinois Securities Corporation made any investment. But I think, generally speaking, that is a proper observation that you have just made.

Again, Mr. Clarke, emphatic in his defense of the good faith with which investments were made, but equally emphatic in condemning the situation which gave rise to them, testified:<sup>195</sup>

Q. In all these situations, Mr. Clarke, do you consider that these were proper investments for the Central-Illinois Securities Corporation, which was popularly known as an investment trust—isn't that so?

A. Yes. Do I consider them proper investments?

Q. I mean, looking back \* \* \* do you consider them proper investments?

A. Most emphatically not, looking back \* \* \* I think we have all learned a lot of lessons, and I think very decidedly it is a mistake for an officer of a commercial bank to have any connection with an investment trust.

Q. I was going to discuss that with you a little bit. I would like to get your reactions on that, because, after all, we are trying to make a study here to see what the difficulties are. This was an investment trust sponsored by a commercial bank.

A. Yes.

Q. Looking back \* \* \* aren't you convinced that all the mistakes or abuses or deficiencies which were prevalent between commercial banks and their security affiliates are equally applicable to a commercial bank with its investment trust?

A. If I followed your question correctly, yes, without any qualification of any kind. I understood you to say that the mistakes that were made in connection with commercial banks with their investment affiliates also applied to the relationship between commercial banks and investment trusts.

Q. Which they sponsored?

A. Yes.

Q. Do you mind elaborating a little bit on the difficulties or mistakes or deficiencies or inadequacies that existed because of this sort of relationship between the commercial bank and investment trust?

A. I would be willing to elaborate to this extent, and that is my own individual experiences endeavoring to conscientiously serve the Central Trust Company as an officer and this Central-Illinois Securities Corporation as an officer are such that nothing could ever induce me to try to function in a dual capacity of that nature.

Q. Put frankly and candidly, Mr. Clarke, that relationship necessarily creates a dual function, particularly in those instances where a trust is dealing either with a bank or with a security affiliate of the bank.

A. That is true.

Q. Every time the investment trust purchases one of the loans from the securities affiliate or purchases a loan from the bank, you were necessarily put in the position where you were acting on both sides of the transaction, isn't that so?

<sup>195</sup> Id., at 1979-83.

A. A very difficult position, and it of course became more accentuated as soon as trouble began to ensue.

Q. Then, it was necessary for individuals who were dominating both of them to make decisions which might sacrifice the interest of one or the other, both ways, isn't that so?

A. Exactly.

Q. You feel there is no useful purpose served in having a commercial bank acting as sponsor to an investment trust?

A. I feel it is very illogical, based on the experience we have had.

Q. Of course, the Banking Act of 1933 does not cure this situation, does it?

A. I think that applies only to investment affiliates.

Q. That applies to either one of two situations; that is confined to those instances where the affiliate is engaged in initiating and distributing and underwriting securities, where it must have a majority on the Board, or this peculiar arrangement of stock ownership, isn't that so?

A. I think so.

Q. So there is nothing to prevent a commercial bank today from organizing an investment trust and having members of it on the Board of the investment trust, provided the investment trust is not engaged in primary or secondary distributions of securities, isn't that so?

A. I think that is the prohibition. Otherwise it is still possible.

Q. But based on your experience you think the healthier thing would be that no commercial bank should sponsor an investment trust and that there should be absolutely no interlocking directorates between the investment trust and the commercial bank, is that it?

A. I feel very emphatically so \* \* \*.

Speaking generally with respect to the interrelationship of commercial banks and investment companies, Mr. Clarke expressed considered judgments which take on added significance in the light of his experience as head of these companies. These observations are set forth with some completeness below, even though fragments of them have been quoted heretofore.<sup>196</sup>

Q. What I would like at the present time, if you would be so good, is for you to just tell us what your experience has been insofar as the effective operation of an investment trust is concerned by individuals who are associated with commercial banks, and particularly where the investment trust has some business relations with these banks or the affiliates of these banks.

Will you just tell us what the problems are and what the difficulties are, both from a theoretical, ethical, or practical standpoint?

A. I possibly lean over backwards in my philosophy of what a commercial bank should confine itself to in the way of financial service. I am absolutely opposed to a commercial bank engaging in the investment business in any way. I don't think the two mix.

Mr. Dawes referred this morning to the department store angle of commercial banks, which I think probably expresses the tendency upon the part of commercial banks to engage in altogether too broad a service a few years ago. I may have swung too far over to the other side, but, aside from a trust business, I feel a commercial bank should confine itself strictly to a bank of deposit and a bank making short-term commercial loans.

As far as the relationship with an investment trust is concerned, particularly where that trust, as was the case with Central-Illinois Securities, has outside stockholders, even though the formation of the company made it very apparent that its operations were to be administered by the same officers that administered the Central-Illinois Company and the Central Trust Company, nevertheless, any conscientious officer will try to administer each one of those three companies for its own best interests.

As long as your security market is stable or inclining upward, as long as you are in a period of reasonable prosperity, I feel that that sort of a relationship is endurable. But, once the reverse takes place, then your officers are in constant embarrassment. I might cite just one or two cases to bring out the point I am trying to make.

<sup>196</sup> Id., at 1985-9.

I recall that the Central-Illinois Securities when it was first organized gave a great deal of consideration to the fact that the stock market had experienced its first violent decline and that listed securities were consequently a good thing to keep out of. They therefore established the principle of looking to the creation of earning assets from what were believed to be good securities, but not subject to the violent fluctuation that was going on in listed equities.

Among some of the assets that were acquired on that basis were a lot of call loans but also a lot of brokers' loans.

I happen to know that the bank turned over to the Central-Illinois Securities about the finest loans that they possessed in their note portfolio. Now that was a very nice accommodation to the Central-Illinois Securities Corporation, but it immediately diminished the earning power of the bank.

Therefore, you are favoring one set of stockholders to the detriment of another set. Later on, these loans, I should say 95% of them, were paid off, but there were one or two that got under water, and immediately the question came up: "Isn't there a moral obligation on the part of the bank to take those loans back?"

\* \* \* \* \*

Nevertheless, that is typical of the kind of a discussion that can ensue, as to whether or not your obligation is to the bank or whether your obligation is to the securities company. And the more conscientious your administrative officers are, the more difficult is their problem, and there are some times when it is almost impossible to decide whether or not this should go to your left hand or whether it should go to your right hand.

And the result was that I think those of us who comprised that administrative personnel, none of these officers were compensated, and they endeavored to do the very best they could under the existing circumstances and reached the unqualified conclusion that it was an inadvisable and impracticable relationship and one that should be terminated within the shortest possible time. I think I can speak for Mr. Dawes as well as for myself. I certainly can speak for myself. The only reason I did not insist that my resignation be accepted at that time from the Central-Illinois Securities so that I could serve only one master was because the banking situation in Chicago, and all of the affiliated situations, were facing problems of such magnitude that there just wasn't time to adjust those relationships then.

Within a few months there came an opportunity to do so, and that is why these gentlemen voluntarily resigned and insisted that the Central-Illinois Securities be officered by independent men properly compensated for giving their entire time and attention to the affairs of this company.

And the comeback that has taken place in the general condition of Central-Illinois Securities is not only a compliment to the ability of the management, but it is also a reflection of the fact that the company can be very much better run through independent personnel.

Mr. Clarke's observations on the evils of the interrelationship of financial institutions and investment companies and the attendant difficulties were admittedly predicated on his belief in the absolute good faith and complete honesty on the part of the interlocking directors. In absence of this good faith, Mr. Clarke readily acknowledged that the evil is aggravated:<sup>197</sup>

Q. \* \* \* Of course, the situation can be even worse where persons who are not conscientious have control of the investment trust \* \* \*.

A. There will be plenty of opportunities for abuses. There isn't any question about that.

Henry M. Dawes, former chairman of the board of directors of the investment company, expressed agreement with the views advanced by Mr. Clarke:<sup>198</sup>

\* \* \* I agree entirely with Mr. Clarke. I think that any practice which confuses the trustee relationship is dangerous and wrong. I don't know that I have any arguments to make further than he did. But I have been thinking,

<sup>197</sup> Id., at 1989.

<sup>198</sup> Id., at 1993.

as he was talking there, about the origin of the things, which seems to me to be rather interesting.

I am not a banker, as you have probably observed, but nevertheless I was Comptroller of the Currency for a couple of years, about thirteen years ago. And I am trying to visualize in my own mind the troubles that came to the big banks, and it seemed to me that nearly all of them were due to just that situation.

And then I wondered why, because by and large 95 percent of these men who are running those banks are honest men, their intentions are good, they didn't want to confuse that trustee relationship—and why they drifted into it. I don't say that there is any point in that, but it occurred to me that it is simply a question of competition. I don't believe that any of us associated with that group of interests out there had any interests or desire to get into this sort of departmental banking that we did. But it just grew out of this competitive situation.

## VI. INVESTMENT COMPANIES ACQUIRED AND CONTROLLED BY WALLACE GROVES

### A. Summary

Wallace Groves, a promoter of small loan companies in Baltimore, Maryland, came to New York in 1931 and began acquiring various independent investment companies to form a holding company system of investment companies to be controlled by him.

With funds borrowed from Franklin Plan Corporation, a holding company of small loan companies, which was under his domination, Mr. Groves in October 1931 purchased control of Interstate Equities Corporation, an investment company, from its sponsor, Bancamerica-Blair Corporation, and its officers, directors, and other insiders, for approximately \$963,000.

Previously, on September 23, 1931, Wallace Groves had contracted to purchase from Chain & General Equities, Inc., another investment company, 467,938 shares of its newly authorized common stock for approximately \$940,000. In order to meet this commitment to purchase the block of Chain & General stock, Mr. Groves, who had assumed control of Interstate Equities Corporation, caused that corporation to agree to purchase this block of Chain & General stock upon condition that Mr. Groves would repurchase the identical block within ten days at approximately the same price. This transaction, although in form a contract of sale and repurchase, was in effect a loan of approximately \$940,000, collateralized by the block of Chain & General stock, which Groves was obligated to buy from Chain & General Equities, Inc. Interstate Equities Corporation, in order to effect this "purchase" of the Chain & General stock from Wallace Groves, had to borrow approximately \$1,000,000 from the National City Bank of New York and to hypothecate \$1,400,000 of marketable securities as security therefor. Had Wallace Groves defaulted on his contract of repurchase, Interstate Equities would have had, in lieu of this \$1,400,000 of marketable securities, a claim against Mr. Groves for approximately \$940,000 and the large block of Chain & General stock as collateral. On November 4, 1931, Wallace Groves used the funds "borrowed" from Interstate Equities Corporation to meet his obligation to purchase the block of Chain & General stock. He immediately took control of the board of Chain & General Equities, Inc. Simultaneously with the payment to that company of the \$940,000 for the block of Chain & General stock, he sold his block of Interstate Equities stock, which had cost him \$963,000, to Chain & General Equities, Inc., for \$1,325,000, with a net profit to him of \$270,000.

On November 5, 1931, out of the \$1,325,000 that he received from Chain & General Equities, Inc., Wallace Groves paid \$282,500 to Yosemite Holding Corporation, another investment company, for a block of 282,500 shares of stock of Yosemite Holding Corporation, constituting 43% of the voting power of that company, which he had contracted to buy on October 7, 1931. Mr. Groves then assumed control of Yosemite Holding Corporation and caused that company on November 16, 1931, to buy, for \$550,000, at a profit to himself, half the block of Chain & General stock which he was committed to repurchase from the Interstate Equities Corporation. In order to raise cash to effect this purchase, Yosemite Holding Corporation was compelled to liquidate practically all the marketable securities in its portfolio at a loss of \$187,612. To meet his obligation to repurchase the

remaining half of the block of Chain & General stock from Interstate Equities Corporation. Wallace Groves caused Franklin Plan Corporation, the small loan holding company, still dominated by him, to purchase this stock, again at a profit to himself, for approximately \$570,000. This sale to Franklin Plan Corporation was conditioned on Mr. Groves' repurchasing this block of Chain & General stock within 90 days.

To meet his repurchase obligation to Franklin Plan Corporation Mr. Groves again did not use his own funds but instead caused companies controlled by him to purchase this Chain & General stock. Mr. Groves first attempted to compel Joint Investors, Inc., a small management investment company, controlled by Yosemite Holding Corporation with a board of directors composed mainly of nominees of Mr. Groves, to purchase from Franklin Plan Corporation approximately half of the stock of Chain & General Equities, Inc., which Mr. Groves was under obligation to repurchase from Franklin Plan Corporation. When, however, a protective committee, formed by Grover O'Neill, the original sponsor of Joint Investors, Inc., refused to submit to a transaction which Mr. O'Neill characterized as "improper" and "crooked," Mr. Groves was forced to seek other sources which would take over his obligation under his repurchase agreement with Franklin Plan Corporation.

Yosemite Holding Corporation thereafter sold for approximately \$100,000 its holdings in Joint Investors, Inc., to the protective committee formed by Grover O'Neill. Yosemite Holding Corporation then immediately used practically all of this amount to purchase a portion of the Chain & General stock from Franklin Plan Corporation. In so doing, Yosemite Holding Corporation exhausted the last of its liquid assets. Once more Mr. Groves sought another source of funds to assume his obligation to repurchase from Franklin Plan Corporation the remainder of the Chain & General stock.

This other source he found in Granger Trading Corporation, an independent investment company with assets of approximately \$200,000 in cash, sponsored by Sulzbacher, Granger and Company, a member firm of the New York Stock Exchange. Mr. Groves caused Yosemite Holding Corporation to purchase control of Granger Trading Corporation with funds borrowed from Chain & General Equities, Inc. Yosemite Holding Corporation bought the holdings of the sponsor, Sulzbacher, Granger and Company, in Granger Trading Corporation at liquidating value and purchased sufficient additional stock from the treasury of Granger Trading Corporation to give Yosemite Holding Corporation control of that company. In addition, Yosemite Holding Corporation paid to Sulzbacher, Granger and Company \$19,500 for the management contract and \$6,000 for cancellation of a lease. Mr. Groves then caused Granger Trading Corporation to sell its assets, consisting of \$200,000 of cash and approximately \$90,000 it had received from Yosemite Holding Corporation for its treasury stock, to Yosemite Holding Corporation, and in return Granger Trading Corporation received 2,701 $\frac{3}{4}$  shares of preferred and 10,807 shares of common treasury stock of Yosemite Holding Corporation, which had practically no asset value.

Thereupon Yosemite Holding Corporation, with the cash it acquired from Granger Trading Corporation, proceeded to purchase additional shares of Chain & General stock from Franklin Plan Corporation. This purchase left a balance of approximately 145,000 shares of Chain & General stock which Mr. Groves was still obligated to repurchase for approximately \$350,000. When Mr. Groves failed to meet this obligation, some stockholders of Franklin Plan Corporation threatened suit and Mr. Groves agreed to a settlement of his repurchase obligation for \$250,000. After paying \$112,500 of this sum, Mr. Groves again defaulted and United States Shares Corporation (Maryland), a company affiliated with the David Milton interests, assumed the balance of his obligation. Shortly thereafter, Franklin Plan Corporation went bankrupt.

By a series of intercompany transactions, therefore, Mr. Groves had sold his control of Interstate Equities Corporation to Chain & General Equities, Inc., and in turn had lodged his control of Chain & General Equities, Inc., in the Yosemite Holding Corporation, which was the top holding company of these investment companies. Mr. Groves himself retained control of Yosemite Holding Corporation by virtue of his holdings of approximately 325,000 shares of Yosemite Holding Corporation common stock. Since this block of Yosemite stock had been purchased by Mr. Groves almost entirely out of profits, his net cost of this block which directly and indirectly controlled an investment company system with aggregate net assets of \$11,000,000, may be considered nominal.

In December 1932 Mr. Groves and one Chase Donaldson and his associates organized The Equity Corporation as a management investment company. Mr.



Groves transferred his approximately 325,000 shares of Yosemite stock, which he had acquired virtually with the profits made on his transactions with his controlled companies, to The Equity Corporation, in return for 1,150,000 shares of The Equity Corporation common stock. Six months later, in May 1933, Mr. Groves sold his holdings of 1,150,000 shares of The Equity Corporation stock to interests affiliated with David Milton for approximately \$1,000,000, which constituted a profit to Mr. Groves substantially in that amount.

The cash used by the Milton interests to pay for The Equity Corporation stock came from Interstate Equities Corporation, the base company of the system headed by The Equity Corporation. Companies controlled by David Milton and his associates, which owned stocks of certain insurance companies, sold these insurance stocks to Interstate Equities Corporation for approximately \$1,000,000 in cash. Immediately after the receipt of this money, the Milton interests paid Mr. Groves approximately \$1,000,000 for his 1,150,000 shares of The Equity Corporation stock.

Within a year and a half, Mr. Groves had acquired control of five investment companies at a nominal cost to himself, and had sold out his control holding of the top company in the holding company system for approximately \$1,000,000.

## **B. Negotiations for the Acquisition of Yosemite Holding Corporation, Chain & General Equities, Inc. and Interstate Equities Corporation by Wallace Groves**

Wallace Groves, a former bond salesman with an investment banking house in Baltimore, Maryland, and later a promoter of small loan companies in Virginia, Maryland, and the surrounding territory,<sup>1</sup> came to New York in 1931 and made an examination of the investment trust field with the intention of acquiring control of investment companies.<sup>2</sup> Within a few months, in September 1931, Mr. Groves entered into negotiations for the acquisition of control of three independent investment companies, Interstate Equities Corporation, Chain & General Equities, Inc., and Yosemite Holding Corporation. Although these companies had suffered severe losses during the depression years of 1930 and 1931, their aggregate net assets amounted to approximately \$11,000,000.

Over a period of two weeks, from September 23, 1931, to October 7, 1931, Mr. Groves, with the assistance and cooperation of dominant interests in these companies, completed his negotiations for the acquisition of control of these three investment companies. Thereafter by using the funds of one investment company to purchase control of another company, Mr. Groves pyramided Chain & General Equities, Inc. upon Interstate Equities Corporation and Yosemite Holding Corporation upon Chain & General Equities, Inc., and obtained control of Yosemite Holding Corporation, the top company. These acquisitions of control were effected without the consent of or adequate disclosure to the preferred or minority common stockholders,<sup>3</sup> and at a substantial personal profit to Mr. Groves.

<sup>1</sup> Public Examination, The Equity Corporation, at 61-3.

<sup>2</sup> Ibid. Mr. Groves became president and principal stockholder of Phoenix Securities Corporation, another investment company, in December 1933 (reply to the Commission's questionnaire for Phoenix Securities Corporation, Pt. I, Exhibit 1-8-E): and subsequently became chairman of its board of directors. (*Poor's Fiscal Volume*, 1938, p. 2635.) Mr. Groves' connection with the management of General Investment Corporation and affiliated companies from August 1936 to March 1937 is discussed infra, pp. 586-7.

<sup>3</sup> No provision in the charters or bylaws of these investment companies required notice to be given to stockholders concerning a contemplated transfer of control. Nor did the laws of Delaware, under which these companies were incorporated, contain any such requirement. Similarly, approval by stockholders of a transfer of control was not required by these charters, by-laws, or statutes.



The outstanding preferred stocks of two of these investment companies, Interstate Equities Corporation and Chain & General Equities, Inc., were "under water," that is, the net assets applicable to the preferred stock of each of these companies were less than the aggregate amount to which the preferred stockholders of each of these companies would be entitled upon liquidation of the companies. The common stocks in these companies, therefore, not only did not have any asset value but actually had a "minus" asset value. The total assets of the companies, of course, would have to increase in an amount greater than the amount that the preferred stocks were "under water" before the common stock would have any asset value. The assets of all three companies, Interstate Equities Corporation, Chain & General Equities, Inc., and Yosemite Holding Corporation, for the most part represented only the equity of the preferred stockholders,<sup>4</sup> almost all of whom were the investing public. Had these companies been liquidated as of the dates of the various contracts entered into by Mr. Groves for the acquisition of their control, virtually all of their assets would have been distributed to the preferred stockholders. However, this liquidation could not be effected without the consent of the common stockholders who controlled the companies although the common stock possessed little or no worth in terms of asset value. Therefore, the value of the common stock reposed primarily in its power to control these funds and in its "leverage."<sup>5</sup>

### C. Acquisition of Interstate Equities Corporation with Funds Borrowed from Franklin Plan Corporation

The first company which was the subject of Mr. Groves' program of acquisition was Interstate Equities Corporation with net assets of more than \$8,600,000.<sup>6</sup> On September 30, 1931, Mr. Groves entered into contracts for the purchase of approximately 46% of the voting stock of Interstate Equities Corporation. Mr. Groves agreed to purchase from the sponsor, Bancamerica-Blair Corporation, 542,517 shares of the common stock of Interstate Equities Corpo-

<sup>4</sup> As at October 7, 1931, the preferred stock of Yosemite Holding Corporation was fully covered and the common stock possessed a net asset value of 17¢ per share. However, Yosemite Holding Corporation's net assets, aggregating \$313,960, represented approximately only 3% of the total net assets of Interstate Equities Corporation, Chain & General Equities, Inc., and Yosemite Holding Corporation, which aggregated \$10,928,468.49. (See notes 6, 19, 72, *infra*.)

<sup>5</sup> For a discussion of the theory of "leverage" see Pt. One (House Doc. No. 707, 75th Cong.) Ch. II, pp. 28-9. Although Mr. Groves testified that he purchased the stock of these companies for their long-term investment possibilities (*op. cit. supra*, note 1, at 77) his subsequent use of the control of these investment companies indicates that his purpose was to facilitate the acquisition by him of one company by using the funds of another without any significant personal risk and at a substantial personal profit.

<sup>6</sup> *Op. cit. supra*, note 1, Commission's Exhibits Nos. 2 and 18. Interstate Equities Corporation had been organized by Bancamerica-Blair Corporation, under the laws of Delaware, on July 29, 1929, with an initial capitalization of \$25,000,000. (*Id.*, at 11 and Commission's Exhibits Nos. 1 and 2.) The company's net assets had fallen by October 20, 1931, to \$8,636,431.40, a decline of approximately 65%. (*Id.*, Commission's Exhibit No. 18.) This value was arrived at by taking the company's investments in stocks and bonds at market or estimated fair value. Evaluating investments at book value, its net assets were \$22,169,681.31. (*Ibid.*) By October 20, 1931, \$2,443,379 had been returned to stockholders as the result of the repurchase of 76,738 shares of preferred stock for which the company had originally received \$3,836,900. (*Id.*, Commission's Exhibit No. 1 and derived from supplementary information supplied the Commission by The Equity Corporation.)

ration at \$1.50 per share for a total of \$813,775.50 to be paid in specified installments, the last of which was to fall due on October 8, 1931.<sup>7</sup> By separate contract, Mr. Groves agreed to purchase from Hunter Marston, a director of both Interstate Equities Corporation and Bancamerica-Blair Corporation, 100,000 shares of the common stock of Interstate Equities Corporation at \$1.50 per share for a total of \$150,000, with a down payment of \$5,000 and the balance due November 5, 1931.<sup>8</sup>

Thus Mr. Groves agreed to pay a total of \$963,775.50 for 642,517 shares of Interstate Equities common stock which had no asset value,<sup>9</sup> presumably in order to acquire a position of dominance over Interstate Equities Corporation which had, as of October 20, 1931, net assets of \$8,636,431.40.

Mr. Groves obtained the funds with which to meet his commitment of \$813,775.50 to Bancamerica-Blair Corporation from Franklin Plan Corporation, a holding company for several small loan companies.<sup>10</sup> Franklin Plan Corporation had been incorporated on March 10, 1931, by Wallace Groves and his brother, George Groves, and stock control of the company was indirectly vested in them.<sup>11</sup> Wallace Groves was not an officer or director of Franklin Plan Corporation, but George Groves was president and a director of the company and a majority of the board of directors consisted of representatives of the Groves interests, namely, William A. Brophy, Samuel C. Taylor, and Albert A. Sommerwerck.<sup>12</sup>

Franklin Plan Corporation did not itself possess \$800,000 to lend to Wallace Groves.<sup>13</sup> Consequently, on October 5, 1931, George Groves ordered the various loan offices under the control of Franklin Plan Corporation to turn over all their cash on hand and in the banks directly to the law firm of Robb, Clark & Bennitt, counsel for Wallace Groves.<sup>14</sup> The money so raised, aggregating approximately \$813,000, was borrowed by Wallace Groves, who used these funds to meet his commitment to purchase 542,517 shares of Interstate Equities Corporation common stock from Bancamerica-Blair Corporation.<sup>15</sup>

<sup>7</sup> Op. cit. supra, note 1, at 81 and Commission's Exhibit No. 10, pars. 1. 2. Mr. Groves agreed to make a down payment of \$150,000 and to pay the balance in installments on October 2, 5, and 8, 1931. (Ibid.)

<sup>8</sup> Op. cit. supra, note 1, at 86-7, and Commission's Exhibit No. 94. The 100,000 shares which Mr. Groves was to purchase from Mr. Marston consisted of stock held by officers, directors, and employees of Bancamerica-Blair Corporation. (Id., at 680, 682-4 and Commission's Exhibits Nos. 91 and 94.) These persons had been on the preferred or selected list of subscribers and had acquired the stock at \$10.15 per share when it was being distributed to the public at \$15 per share. (Id., at 676-7 and Commission's Exhibit No. 91.)

<sup>9</sup> Id., Commission's Exhibit No. 18. The estimate of the net asset value of Interstate Equities Corporation common stock is based on an independent audit by Bayer & Clauson, certified public accountants, as of October 20, 1931, which stated the asset value of the Interstate common stock was minus 11¢ per share. According to the company's own figures the Interstate common stock had a net asset value of 43¢ per share as of November 13, 1931. On this basis, the 642,517 shares which Mr. Groves was purchasing possessed an aggregate net asset value of \$276,282.31. Consequently, according to these figures, Mr. Groves was paying a premium of \$687,493.19 over asset value, a premium of 240%. (Id., Commission's Exhibits Nos. 16, 17.)

<sup>10</sup> Op. cit. supra, note 1, at 297.

<sup>11</sup> Id., Commission's Exhibit No. 34.

<sup>12</sup> Id., at 298-9 and Commission's Exhibit No. 34.

<sup>13</sup> Id., at 300.

<sup>14</sup> Ibid., and Commission's Exhibit No. 34.

<sup>15</sup> Id., at 86, 300, and Commission's Exhibit No. 34.

The books of account of Franklin Plan Corporation at first carried the loan in a special account under the name of George Groves, and subsequently under the name of Growart Corporation, a personal holding company of Wallace Groves.<sup>16</sup> The books carried the notation that the loan was secured by a note signed by Growart Corporation and by 542,517 shares of Interstate Equities Corporation common stock,<sup>17</sup> and was guaranteed by Wallace Groves. However, Bernard H. Kummel, treasurer and assistant secretary of Franklin Plan Corporation, testified that he received no note or collateral:<sup>18</sup>

Q. Do you know if there was any collateral put up for this loan?

A. That again, I do not know.

Q. There was none given to you as assistant treasurer, was there?

A. No, sir.

Q. And there was no note given to you as assistant treasurer?

A. No, sir.

#### **D. Acquisition of Chain & General Equities, Inc., with Funds Borrowed from Interstate Equities Corporation**

The second company, the control of which Mr. Groves purchased, was Chain & General Equities, Inc., with net assets of approximately \$2,000,000.<sup>19</sup> The agreement between Mr. Groves and the investment company, dated September 23, 1931, provided that the authorized number of shares of common stock of the company was to be increased and that 470,400 of such shares were to be offered to the company's common stockholders at \$2 per share.<sup>20</sup> Mr. Groves undertook to purchase on November 4, 1931, at this price all unsubscribed shares plus any additional shares necessary to give him 51% of the total outstanding voting power.<sup>21</sup> However, this right of the stockholders to subscribe was an illusory one. Inasmuch as the bid and asked prices of the Chain & General common stock, at about this time, were \$1 and \$1 $\frac{3}{4}$  respectively, it was probably surmised that the stockholders

<sup>16</sup> Id., at 300 and Commission's Exhibit No. 34.

<sup>17</sup> Id., Commission's Exhibit No. 34.

<sup>18</sup> Id., at 302.

<sup>19</sup> Chain & General Equities, Inc., which had been organized by the investment banking firm of Childs, Jefferies & Company, Inc., of Boston, Mass., on February 4, 1929, under the laws of Delaware, had raised \$8,000,000 from the public through the sale of its security issues. (Id., at 1715-6, 1733, and Commission's Exhibit No. 219.) By September 30, 1931, the company's net assets, with its portfolio holdings computed at market or estimated fair value, totaled \$1,978,077.09, representing a decline of 75%. (Id., Commission's Exhibit No. 9.) By September 30, 1931, approximately \$942,000 had been returned to stockholders, as a result of the repurchase by the company of 14,467 shares of its outstanding preferred stock and 3,200 shares of common stock, for which stocks the company had originally received \$1,526,700 from the public. (Id., Commission's Exhibits Nos. 9 and 10, and derived from supplementary information supplied the Commission by The Equity Corporation.)

<sup>20</sup> Op. cit. supra, note 1, Commission's Exhibit No. 8. The authorized capital stock of the company had consisted of 86,842 shares of \$100 preferred stock, and 400,000 shares of no par value common stock of which there were outstanding 26,394 shares of preferred and 156,800 shares of common stock. (Id., Commission's Exhibit No. 8.) Each share of preferred and common was entitled to one vote. (Id., Commission's Exhibit No. 219.)

<sup>21</sup> Op. cit. supra, note 1, Commission's Exhibit No. 8. The privilege accorded to stockholders to subscribe for the new issue of stock was patently granted because of the existence of preemptive rights of the stockholders.

would not exercise their subscription rights, and that Mr. Groves would be permitted to purchase all the newly authorized stock.<sup>22</sup> In fact, only 2,462 shares of the new issue of common stock were taken down by the Chain & General Equities, Inc., stockholders and Mr. Groves was therefore able to purchase 467,938 shares for a total price of \$935,876.<sup>23</sup> This stock gave Mr. Groves approximately 72% of the voting power of the company.

The agreement further provided that upon payment by Mr. Groves for the new Chain & General Equities, Inc., stock, such directors as he should designate would resign and he would be permitted to have his nominees elected.<sup>24</sup> The agreement also contained an assurance by Mr. Groves that Chain & General Equities, Inc., would continue as a general management type of investment company.<sup>25</sup>

The common stock of Chain & General Equities, Inc., had no asset value and the 25,533 outstanding shares of \$100 par value preferred stock were "under water" to the extent of \$22.53 per share plus accrued unpaid dividends of slightly more than \$4.58 per share, or a total of \$692,249.20 as of September 30, 1931. Therefore \$692,249.20 of the \$935,876 which Mr. Groves agreed to pay into the treasury of Chain & General Equities, Inc., would have to be allocated to the preferred stock before the common stock would possess any asset value.<sup>26</sup> The balance of \$243,626.80 allocable to the 627,200 shares of common stock which would be outstanding after Mr. Groves met his commitment would give the common stock an asset value of approximately 39¢ per share.<sup>27</sup> Thus Mr. Groves, in purchasing 467,938 shares of Chain & General common stock at \$2 per share, was paying \$935,876 for stock which possessed, after payment by him, an aggregate asset value of \$182,495.82, or a premium over asset value of about 410%. Apparently Mr. Groves' willingness to put almost \$1,000,000 into the treasury of Chain & General Equities, Inc., was influenced by the desire to control the other \$2,000,000 of the company's assets. As will be indicated, Mr. Groves employed a portion of these assets to facilitate his acquisition of other investment companies.

Even before Mr. Groves had advanced any money on this contract, the management permitted him to assume a dominant position on the board. On October 16, 1931, Mr. Groves was elected a director.<sup>28</sup> On October 28, 1931, Paul H. Byers, Walter S. Mack, Jr., and Frederick Fisher, as nominees of Mr. Groves, were elected to the board, which then consisted of ten members.<sup>29</sup> Although Mr. Groves de-

<sup>22</sup> *Bank and Quotation Record*, November 6, 1931, p. 82.

<sup>23</sup> Derived from supplementary information supplied the Commission by The Equity Corporation.

<sup>24</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. 8.

<sup>25</sup> *Id.*, Commission's Exhibit No. 8.

<sup>26</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. 9. See also note 46, *infra*.

<sup>27</sup> *Id.*, at 75-7, and Commission's Exhibit No. 9. See also note 46, *infra*.

<sup>28</sup> Derived from supplementary information supplied the Commission by The Equity Corporation.

<sup>29</sup> *Op. cit. supra*, note 1, at 89. The other members were: Gerald F. Beal, George A. Morison, W. E. Burnet, Paul D. Childs, J. Amory Jeffries, William B. Nichols, and Wallace Groves. (Derived from supplementary information supplied the Commission by The Equity Corporation.)

nied that his nominees represented his interest,<sup>30</sup> the record indicates an association among them which might make them amenable to his wishes.

Messrs. Byers, Fisher, Mack, Nichols, Childs, and Jeffries were members of the investment banking firm of William B. Nichols & Company, Inc.,<sup>31</sup> which was the successor firm to Child, Jeffries & Company, Inc., the sponsor of Chain & General Equities, Inc. In connection with his acquisition of control of Chain & General Equities, Inc., Mr. Groves agreed to compensate William B. Nichols & Company, Inc., for options held by it to purchase Chain & General Equities, Inc., stock and to pay the company for "services" rendered the investment company in negotiating its transfer to Mr. Groves.<sup>32</sup> Mr. Groves also agreed that William B. Nichols & Company, Inc., would receive from Chain & General Equities, Inc., a two-year-management contract, which was subsequently executed on November 2, 1931.<sup>33</sup> Paul D. Childs, a member of Childs, Jeffries & Company, Inc., the predecessor of William B. Nichols & Company, Inc., admitted the influence which arose from an interest in the management contract. He testified:<sup>34</sup>

Q. I think our transcript indicates that at the meeting Childs, Jeffries, Nichols and Mack did not vote because they were interested parties. How were you interested?

A. What meeting is this?

Q. That is the meeting of September 23rd. It said, "The letter contract of Wallace Groves \* \* \* approved. Battles dissenting; Childs, Jeffries, Nichols and Mack did not vote because they were interested parties." Do you remember that meeting?

A. Yes.

Q. Was that because the agreement made provisions for a management contract with William B. Nichols and Company? How were you interested, in the sense you could not participate in the vote?

A. Well, we were interested in the situation as to the management. Have you a copy of that contract there?

Q. Yes.

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<sup>30</sup> Op. cit. supra, note 1, at 89-90. It is significant that Frederick Fisher, one of Mr. Groves' "independent" nominees to the board of Chain & General Equities, Inc., made an effort to restrain the Securities and Exchange Commission from conducting public examinations into investment trusts. The initial hearings were to be devoted, in part, to Mr. Groves' relations with Chain & General Equities, Inc., Interstate Equities Corporation, and Yosemite Holding Corporation.

On July 27, 1936, the complainant Fisher filed two suits, one in his individual capacity and one as a stockholder of The Equity Corporation, challenging the validity of subpoenas issued by the Commission in its investigation into investment trusts conducted pursuant to Section 30 of the Public Utility Holding Company Act of 1935. In the former suit, Mr. Fisher sought to enjoin the individual Commissioners from compelling his appearance pursuant to subpoenas, from issuing any further subpoenas, and from taking any steps to cause him to be prosecuted for refusal to obey these subpoenas. In the companion suit which named as defendants, in addition to the Commissioners, The Equity Corporation and its officers and directors, the complainant sought to restrain the Commission from taking any action to compel the giving of evidence by the latter persons, or the prosecution of such persons for failing to give evidence, and also sought to enjoin such persons from appearing and testifying at the inquiry. On August 11, 1936, the District Court for the District of Columbia denied the motions for preliminary injunctions on the ground of want of equity. (Third Annual Report of the Securities and Exchange Commission, 1936-1937, p. 52.)

<sup>31</sup> Op. cit. supra, note 1, at 89, 1801.

<sup>32</sup> Id., Commission's Exhibit No. 8.

<sup>33</sup> Derived from supplementary information supplied the Commission by The Equity Corporation.

<sup>34</sup> Op. cit. supra, note 1, at 1801.

A. I think it outlines—that is the contract. It seems to me that would be plenty, wouldn't it, because we were interested in the management contract? Mr. Groves had agreed with us that if this plan went through he would extend that management contract and make it longer.

Q. And you were associated with that, is that it?

A. That is right.

As will be seen, on November 4, 1931, Mr. Groves acquired undisputed control of the board of Chain & General Equities, Inc.<sup>35</sup> On that date, his commitment to purchase from Chain & General Equities, Inc., 467,938 shares of the common stock of Chain & General Equities, Inc., for a total price of \$935,876 matured.<sup>36</sup> This obligation, together with the commitments to purchase the stocks of the other investment companies, increased his obligations to \$2,241,030.30.<sup>37</sup> When questioned as to whether his personal resources were sufficient to carry out any commitment he might undertake, Mr. Groves testified:<sup>38</sup>

A. \* \* \* I think I had substantial means, certainly enough to carry out any contract I would make.

Q. To the extent of \$1,000,000

A. Yes, sir. I either had it or could procure it.

Q. Or could get it?

A. Yes, sir, or else I wouldn't have made the commitment.

Q. Did you have any bankers group organized or any purchase group organized to share this commitment with you?

A. No, sir.

Q. You were carrying it out yourself?

A. That was my idea.

\* \* \* \* \*

Q. Would you say that on October 7, 1931, your net worth was sufficient to meet all these commitments when they matured?

A. I would say my net worth, and plus that, I could have borrowed money if I needed to.

Actually, however, Mr. Groves fulfilled his obligation to purchase the Chain & General common stock with funds borrowed from Interstate Equities Corporation (control of which he had secured approximately three weeks before by use of the funds of Franklin Plan Corporation). Mr. Groves had become director of Interstate Equities Corporation and a member of its executive committee.<sup>39</sup> On the morning of November 4, 1931, Mr. Groves entered into a contract with Interstate Equities Corporation pursuant to which Interstate Equities Corporation agreed to purchase from him 469,698 shares of

<sup>35</sup> Derived from supplementary information supplied the Commission by The Equity Corporation. Messrs. Beal, Burnet, Jeffries, Morison and Childs resigned as directors, and Messrs. Ewart, Robinson, Brophy, Warriner, Rogerson, and Taylor were elected as the new directors.

<sup>36</sup> Op cit. supra, note 1, Commission's Exhibit No. 8.

<sup>37</sup> Mr. Groves owed Franklin Plan Corporation \$813,775.50. He had a commitment, already two days overdue, on November 4, 1931, to take up 282,500 shares of Yosemite Holding Corporation common stock for a balance of 277,500. (Id., at 238-9 and Commission's Exhibit No. 2. 28; see infra.) In addition, he still had to pay a balance of \$145,000 to Hunter Marston for 100,000 shares of Interstate Equities Corporation common stock. (Id., at 250.) A contract to purchase Yosemite warrants from Baker, Simonds & Company added \$50,878.80 to his commitments. (Id., at 242-5; see infra.) Finally, Mr. Groves had an obligation to Interstate Equities Corporation, incurred October 14, 1931, to pay \$18,000 for 12,000 shares of the common stock of Interstate Equities Corporation within 90 days. (Derived from supplementary information supplied the Commission by The Equity Corporation.)

<sup>38</sup> Op. cit. supra, note 1, at 71-2, 242.

<sup>39</sup> Id., Commission's Exhibit No. 94.

Chain & General common stock at \$2 per share for a total of \$939,396. This was the identical block of Chain & General stock which Mr. Groves was obligated to buy from Chain & General Equities, Inc.<sup>40</sup> Delivery to Interstate Equities Corporation was to be made at 15 Exchange Place, Jersey City, New Jersey, at 11 A. M., the exact time and place at which he was to pick up the block of Chain & General common stock from Chain & General Equities, Inc. Mr. Groves also agreed to repurchase from Interstate Equities Corporation the identical shares of Chain & General stock within ten days for \$940,479.92.<sup>41</sup> Although the entire transaction took the form of a purchase and repurchase agreement, in effect Interstate Equities Corporation was making a loan to Mr. Groves with the Chain & General stock as collateral.<sup>42</sup>

Pursuant to this contract Interstate Equities Corporation turned over to Mr. Groves, on the morning of November 4, 1931, a check drawn on The National City Bank of New York for \$939,396.<sup>43</sup> Mr. Groves immediately paid over this money to Chain & General Equities, Inc., in fulfillment of his commitment to pick up the 467,938 shares of Chain & General stock.<sup>44</sup>

Q. Isn't it a fact that Interstate Equities had a check issued by The National City Bank payable to Chain & General for \$936,000 and some odd dollars?

A. If you say so. I don't know who the check was payable to. I assume it was.

Q. Now, this check that you got for \$936,000, that was the check that you took over to Chain & General Equities and paid for the stock you had contracted to purchase? Isn't that so?

A. I assume that it was, yes.

## 1. BORROWING BY INTERSTATE EQUITIES CORPORATION TO MAKE LOAN TO WALLACE GROVES

In this manner Interstate Equities Corporation in effect lent to Wallace Groves, a director and the controlling stockholder of the investment company, approximately \$940,000 to enable him to meet his commitment to purchase the Chain & General stock. Interstate Equities Corporation, however, did not have the necessary cash to make this "loan." Consequently, on November 4, 1931, Interstate Equities Corporation borrowed \$1,000,000 from The National City Bank of New York, pledging as collateral securities in its portfolio with an aggregate market value of \$1,412,125.<sup>45</sup>

Thus, the National City Bank of New York acquired from Interstate Equities Corporation as collateral marketable securities with an aggregate market value of over \$1,400,000. On the other hand, Interstate Equities Corporation received from Mr. Groves under the purchase and repurchase arrangement, in effect

<sup>40</sup> Id., Commission's Exhibits Nos. 8 and 11. Interstate Equities Corporation agreed to purchase from Mr. Groves 1,760 shares more than he was obligated to buy from Chain & General Equities, Inc. The disparity was subsequently adjusted.

<sup>41</sup> Op. cit. supra, note 1, Commission's Exhibit No. 11.

<sup>42</sup> Id., at 118.

<sup>43</sup> Id., at 94-5, and Commission's Exhibit No. 13.

<sup>44</sup> Id., at 94-5.

<sup>45</sup> Id., at 95, and Commission's Exhibit No. 13.



as collateral, 467,938 shares of Chain & General Equities, Inc. common stock which on November 4, 1931, was worthless in terms of asset value.<sup>46</sup> In terms of market value, too, the Chain & General common stock apparently had a mere speculative worth.<sup>47</sup> Had Mr. Groves defaulted on his repurchase obligation, Interstate Equities Corporation would have had, in lieu of liquid securities, a claim against Wallace Groves for approximately \$940,000 secured by a large block of Chain & General Equities, Inc. common stock without asset value.<sup>48</sup>

### E. Sale by Wallace Groves of Interstate Equities Corporation Stock to Chain & General Equities, Inc.

On November 4, 1931, the same day that Wallace Groves paid for the 467,938 shares of Chain & General stock with the funds "borrowed" from Interstate Equities Corporation, Mr. Groves' nominees, Clifford B. Ewart, Wilfred S. Robinson, Ernest B. Warriner, Waverly Rogerson, William A. Brophy, and Samuel C. Taylor were elected to the board of directors of Chain & General Equities, Inc., in place of Messrs. Beal, Burnet, Jeffries, Morison and Childs.<sup>49</sup> Almost all of the new directors had had previous business connections with Mr.

<sup>46</sup> That the Chain & General Equities, Inc., common stock possessed no asset value is shown by the following (op. cit. supra, note 1. Commission's Exhibits Nos. 9, 11, and 17 and derived from supplemental information supplied the Commission by The Equity Corporation):

(1) The Chain & General Equities, Inc., \$100 preferred stock was "under water" \$22.53 per share plus approximately \$4.58 per share for accrued unpaid dividends, a total impairment of \$692,249.20.

(2) The \$935,876 which Chain & General received into its treasury for the sale of 467,938 shares of Chain & General Equities, Inc., common stock to Mr. Groves, eliminated this impairment and left a balance of \$243,626.80 applicable to all the then outstanding 627,200 shares of Chain & General Equities, Inc., common stock, or 39¢ per share.

(3) On November 4, 1931, after the receipt of \$935,876 shown in (2), Chain & General Equities, Inc., paid \$1,325,034 in cash in purchasing from Groves 642,517 shares of Interstate Equities common.

(4) The asset value of the Interstate Equities Corporation common stock, even as computed by the company on November 13, 1931, the nearest date available, was only 43¢ per share, or a total of \$276,282.31 for the 642,517 shares of Interstate Equities common stock received by Chain & General Equities, Inc.

(5) Thus the purchase of Interstate Equities Corporation common stock having an asset value of \$276,282.31 for \$1,325,034 in cash, decreased the net assets of Chain & General in the amount of \$1,048,751.69, reducing the amount of net assets available for Chain & General Equities, Inc., common stock from \$243,626.80 to a point where it had no asset value. In fact, on this basis the preferred stock was again "under water" to the extent of \$805,124.89, or \$31.53 per share.

<sup>47</sup> The over-the-counter market prices for the month-ends of October and November 1931, respectively, were:

	<i>Bid</i>	<i>Asked</i>
October-----	\$1	\$1 $\frac{3}{4}$
November-----	1 $\frac{1}{4}$	2

The bid price declined steadily to  $\frac{1}{8}$  within 7 months (Bank and Quotation Record, November 6, 1931, p. 82; December 4, 1931, p. 82).

<sup>48</sup> Op. cit. supra, note 1, at 114-6.

<sup>49</sup> Id., at 96, and derived from supplementary information supplied the Commission by The Equity Corporation.



Groves.<sup>50</sup> In addition, the board of nine members included three other nominees of Mr. Groves—Messrs. Byers, Mack and Fisher.<sup>51</sup>

Immediately after Mr. Groves' nominees had been installed as directors of Chain & General Equities, Inc., Mr. Groves submitted an offer to sell to Chain & General Equities, Inc., his block of common stock of Interstate Equities Corporation. This block consisted of the 542,517 shares of Interstate Equities Corporation common stock which he had already purchased from Bancamerica-Blair Corporation and the 100,000 shares of Interstate Equities Corporation common which he had undertaken to purchase from Hunter Marston but for which he had not yet fully paid. The price of this stock to Wallace Groves was \$1.50 per share, or a total of \$963,775.50.<sup>52</sup> The price at which Mr. Groves offered the stock to Chain & General Equities, Inc., was \$1,325,034, or a price of approximately \$2.06 per share.<sup>53</sup> After the offer was read, Mr. Groves withdrew from the meeting<sup>54</sup> and the new directorate, composed entirely of his nominees, accepted the offer.<sup>55</sup>

The net effect of these transactions was that almost simultaneously with the payment by Wallace Groves of approximately \$936,000 (funds which he "borrowed" from Interstate Equities Corporation) to Chain & General Equities, Inc., for the block of Chain & General stock (the block which had been "hypothecated" by Mr. Groves, as collateral for the loan to him from Interstate Equities Corporation), Mr. Groves sold to Chain & General Equities, Inc., his block of Interstate Equities stock for \$1,325,034. As a consequence, Mr. Groves almost immediately received back from Chain & General Equities,

<sup>50</sup> Messrs. Groves and Ewart had both been directors of Growart Corporation, a company controlled by Mr. Groves. (Cf. op. cit. supra, note 1. Commission's Exhibit No. 34.) Messrs. Taylor and Brophy, as directors of Franklin Plan Corporation, had been instrumental in causing Franklin Plan Corporation to lend Mr. Groves the money with which he purchased control of Interstate Equities Corporation. (Id., Commission's Exhibit No. 34.) Mr. Warriner had negotiated Mr. Groves' acquisition of Interstate Equities Corporation from Bancamerica-Blair Corporation and had received from Mr. Groves a commission of \$15,000 for his services. (Id., at 1832-4.) Mr. Robinson was a personal friend of Mr. Warriner, and Mr. Rogerson was apparently a "dummy" director who resigned the same day he was elected, to permit the election of Mr. Groves as a director. (Public Examination, General Investment Corporation, at 15141-4, and derived from supplementary information supplied the Commission by The Equity Corporation.)

<sup>51</sup> Mr. Groves had been elected a director of Chain & General Equities, Inc., on October 16, 1931, but had resigned on November 2, 1931. (Derived from supplementary information supplied the Commission by The Equity Corporation.)

<sup>52</sup> Op. cit. supra, note 1, at 98, and notes 7 and 8 supra.

<sup>53</sup> Derived from supplementary information supplied the Commission by The Equity Corporation.

<sup>54</sup> Paul D. Childs, a sponsor of Chain & General Equities, Inc., testified on the significance of the withdrawal of interested directors (op. cit. supra, note 1, at 1761-2):

Q. \* \* \* Mr. Groves stepped out of the meeting every time there was a vote on one of his transactions, too, and what significance has this stepping out of the meeting? Isn't that just a gesture? The thing is all agreed on before, and you just step out and it is voted on, and you step back, isn't that so?

A. That is true, and of course if they disagree you don't come to that point of the meeting.

Q. Stepping out usually didn't take place until you have convinced the Board of Directors that it is the thing for them to do; isn't that so? I mean, you are not trying to impress anybody with the fact that you stepped out, that has no significance, isn't that true? They all step out, don't they, when it comes to voting on transactions where they are trying to sell the trusts stock that belongs to themselves? That is the usual procedure?

A. That is true.

<sup>55</sup> After the acceptance of the offer, Waverly Rogerson resigned as director and Mr. Groves was elected to the vacancy. (Derived from supplementary information supplied the Commission by The Equity Corporation.)

Inc., not only the approximately \$936,000 in cash that he had paid that company, but approximately \$400,000 in cash in addition. The sale of the Interstate Equities stock to Chain & General Equities, on November 4, 1931, was effected at a substantial profit to Mr. Groves. That block had cost him \$963,775.50 together with fees, commissions, and expenses aggregating \$90,188.78<sup>56</sup> so that Mr. Groves made a net profit on the transaction of \$271,069.72.

The absence of arm's-length dealing and opportunity for over-reaching in this transaction was pointed out by Paul H. Byers, one of Mr. Groves' "independent" nominees to the board of directors of Chain & General Equities, Inc. In a "private and confidential" memorandum to Mr. Groves concerning an earlier offer made by Mr. Groves on November 2, 1931, to sell this block of Interstate Equities Corporation common stock to Chain & General Equities, Inc.,<sup>57</sup> Mr. Byers attempted to persuade him to take a smaller profit than was contemplated. The memorandum stated:<sup>58</sup>

*Private and Confidential*

Memorandum to Mr. Groves:

The time problem seems unimportant and surely can be solved.

The price-profit problem seems more serious. You asked me my opinion Tuesday evening and I had none. Further consideration, partly during a spell of wakefulness last night, have raised certain points that seem worth passing on.

We may seem to you unduly sensitive to public, or rather informed financial opinion. The reason is that those who disregard this opinion seem, in the end, to be "unlucky." This is not a matter of law, although there is a question there raised by Burleigh [Berle], I believe, of Columbia, but of what the right people consider sound practice in the year 1931.

All the details will become known. The aspect of dealing with oneself will be more obvious to outsiders than to those of us who have followed the affair. It will place a heavy responsibility on the independent directors who will have to decide, and of course involve disclosure of interest to them. They are anxious to work with us, but must think of themselves, too.

Due to the decline in asset value since purchase, may they not be fearful that outsiders will assume that you were stuck with a commitment, in a falling market, and got out with a profit by marking the price up 50% and unloading it on another company under your control. The profit being \$406,500, less commissions, in the course of a few weeks, on an investment of \$813,000. An upward movement which would have increased the asset value of the stock would have put quite a different light on it.

The question is not one of the stock's value in assets, nor for control, nor whether you are entitled to some profit, which you obviously are, nor whether the purchase at any reasonable price would be a good thing for Chain & General, which it would. We agree about all that.

The question is, as a practical matter, how and what price, nothing more. Cravath agree [sic] with us that the time element may be taken care of by a bank loan, which if you wish, we can endeavor to arrange.

But the 50% mark-up, if it could be changed into a sum sufficient to cover your out-of-pocket, leaving profit till later, would be much easier to handle.

<sup>56</sup> The expenses consisted of (a) \$48,188.78 commissions paid to the New York Stock Exchange firm of Babcock, Rushton & Co.; (b) \$15,000 interest on the loan of approximately \$800,000 from Franklin Plan Corporation; (c) \$2,000 in stamps; (d) \$10,000 in legal fees to Robb, Clark & Bennett; (e) \$15,000 in commissions to Ernest B. Warriner for facilitating Mr. Groves' acquisition of Interstate Equities Corporation. (Derived from supplementary information supplied the Commission for The Equity Corporation.)

<sup>57</sup> Derived from supplementary information supplied the Commission by The Equity Corporation. Mr. Groves had resigned from the board of Chain & General Equities, Inc., on November 2, 1931, in anticipation of that offer. (Ibid.)

<sup>58</sup> Op. cit. supra, note 1, Commission's Exhibit No. 12.

less dangerous, easier for the director, lawyers, and ourselves. Would not 40 cents a share on the whole 642,000, or about a quarter of a million do this?

People in these parts draw a line, sometimes a very fine one, between making money *with* your stockholders and making it *out of* them. The trouble with the [names of certain investment and commercial bankers omitted] even, was that they didn't recognize that line, and that as you know is what has been the matter with most trusts we study. It is what everyone will look for in a new man in the field. A suspicion of it, and acquisition would be impossible with certain firms. If we can be like Caesar's wife from the beginning, it will be a damn good investment. Don't you agree?

PHB.

Mr. Groves withdrew this original offer and on November 4, 1931, submitted another offer to the directors of Chain & General Equities, Inc., which, as has been pointed out, resulted in a net profit to Mr. Groves of over \$270,000.

## 1. PAYMENT OF PREMIUM BY CHAIN & GENERAL EQUITIES, INC., FOR INTERSTATE EQUITIES CORPORATION STOCK

The price of \$1,325,034, or approximately \$2.06 per share, for the 642,517 shares of Interstate Equities common stock paid by Chain & General Equities, Inc., to Mr. Groves was substantially higher than even the book asset value of the Interstate Equities common stock.<sup>59</sup> Mr. Groves, although conceding that Chain & General Equities, Inc., while under his control, had paid him \$1,325,034 for stock possessing little, if any, asset value,<sup>60</sup> denied that the transaction was unfair:<sup>61</sup>

Q. The fact of the matter is that Bayer and Clauson stated in their report the net asset value of 1,238,000 shares of common stock, giving effect to the redemption price of \$55 per share for preferred stock value after allowance for accrued dividends per share, was minus 11 cents; and the value without allowance for accrued dividends, was 1 cent? Isn't that so?

A. That appears so.

Q. Now, on the basis of the valuation of the accountants of Chain & General Equities made in connection with this purchase that \$1,325,000 that was paid to you personally by Chain & General Equities and approved by the Board of Directors composed of the majority of your nominees, was not only valueless but minus 11 cents a share?

A. You are deliberately misleading everyone here when you state that. The value of the company as a liquidated company is one thing. The value of a stock that has assets of some nine million dollars may vary from a few cents to a few dollars, but would not show its sale value or its fair value.

Commissioner HEALY. Let us take it on the basis of liquidating value first.

By Mr. SCHENKER:

Q. On the basis of liquidating value——

The WITNESS: I think he has given you the statement on the basis of liquidating value.

## 2. CHANGE IN INVESTMENT POLICY OF CHAIN & GENERAL EQUITIES, INC.

Chain & General Equities, Inc. had been avowedly organized as a means of providing investors with the opportunity of placing their funds in a diversified list of securities. The offering circulars em-

<sup>59</sup> Id., Commission's Exhibits Nos. 9 and 117; and see note 9, supra.

<sup>60</sup> Ibid.

<sup>61</sup> Id., at 140-41.

phasized that "the primary purpose of the Corporation is to provide investment safety based upon broad diversification of security holdings, chiefly in chain stores."<sup>62</sup> This policy of diversification was adhered to during the period in which the trust was under the control of its sponsor, Childs, Jeffries & Company, Inc. When the individuals constituting the management agreed on September 23, 1931, to transfer control of the company to Wallace Groves, they obtained the written assurance from him that he would continue to operate the company as an investment company of the general management type. The contract stated:<sup>63</sup>

I wish to assure you that it is my intention, in acquiring a controlling interest in the Common Stock of your Corporation, to cause the business of your Corporation to be continued as that of a general management investment trust, and not to divert or permit the diversion of the assets of your Corporation to other purposes, and so far as lies within my power and the power of my representatives of the Board of Directors, to maintain such policy as the policy of the Corporation, it being understood, however, that the Corporation may depart from this policy if and to the extent that a majority of the independent directors on the board (that is, directors not chosen by me) shall agree to such departures.

However, Mr. Groves, immediately upon assuming control of Chain & General Equities, Inc. on November 4, 1931, caused that company to place \$1,325,034, or about 45% of its total gross assets, in a single specialized investment purchased from Mr. Groves, the common stock of Interstate Equities Corporation, another investment company.<sup>64</sup> When examined on this phase of his management of Chain & General Equities, Inc., Mr. Groves denied that he had departed from his obligation to maintain Chain & General Equities, Inc. as a general management trust.<sup>65</sup>

Q. \* \* \* Now the fact of the matter is that on the very day, November 4, when you took control of Chain & General Equities, you sold Chain & General Equities \$1,325,000 of Interstate Equities stock which was substantially the control of the outstanding common stock of Interstate Equities Corporation? Isn't that so?

A. Yes.

Q. And was that your concept of a general investment that conformed to your obligation under this contract?

A. I fully conformed to my obligation.

### 3. NONDISCLOSURE TO STOCKHOLDERS OF CHAIN & GENERAL EQUITIES, INC.

The public shareholders of Chain & General Equities, Inc. were never adequately informed of the dealings between the investment company and its controlling stockholder, Wallace Groves. Information as to the material facts of this relationship was either entirely omitted, or only partially disclosed. As has been indicated, Paul H. Byers, a director of Chain & General Equities, Inc. was aware of the dangers involved in full publicity, for in his memorandum to Mr. Groves dealing with the sale by Mr. Groves of the Interstate Equities common stock to Chain & General Equities, Inc., Mr. Byers stated:<sup>66</sup>

<sup>62</sup> Id., Commission's Exhibit No. 221.

<sup>63</sup> Id., Commission's Exhibit No. 8.

<sup>64</sup> Id., at 99-100, and Commission's Exhibit Nos. 8, 9.

<sup>65</sup> Id., at 148.

<sup>66</sup> Id., Commission's Exhibit No. 12.

We may seem to you unduly sensitive to public, or rather informed financial opinion. The reason is that those who disregard this opinion seem, in the end, to be "unlucky" \* \* \*.

All the details will become known. The aspect of dealing with oneself will be more obvious to outsiders than to those of us who have followed the affair.

The report to stockholders of Chain & General Equities, Inc. for the quarter ending September 30, 1931 emphasized that Wallace Groves was underwriting an issue of Chain & General stock and that the funds so raised would aid appreciably in reviving the weakened financial condition of the company.<sup>67</sup> The letter of the president, dated October 31, 1931, accompanying the report, stated in part:<sup>68</sup>

The new capital to be received will strengthen materially the financial position of your Company. The providing of a large amount of additional cash at this time of depressed values should place your Company in a good position to take advantage of opportunities now available to those with cash in hand.

This statement was dated October 31, 1931, two days before Mr. Groves submitted his first offer to sell to Chain & General Equities, Inc. the common stock of Interstate Equities Corporation.<sup>69</sup> Although Mr. Groves was apparently negotiating the sale of Interstate Equities stock to Chain & General Equities, Inc. at the time this letter was written, no hint of this proposed sale was given to the stockholders. The new capital in the form of additional cash, which was furnished by Mr. Groves, was immediately turned back to Mr. Groves in payment for the block of Interstate Equities stock which he sold to Chain & General Equities, Inc. at a substantial profit. It was not until the end of the following quarter that even partial disclosure of this transaction was made.

The next report of Chain & General Equities, Inc., for the period ending December 31, 1931,<sup>70</sup> revealed that Chain & General Equities, Inc. had used the new capital to purchase control of Interstate Equities Corporation, but failed to disclose that the purchase had been made from Wallace Groves or that he had realized a net profit on the deal of over \$270,000. Mr. Groves conceded that full disclosure had not been made to the stockholders:<sup>71</sup>

Q. And there is a statement that this million dollars which you were supposed to contribute was contributed? Isn't that so?

A. Yes.

Q. And then it goes on: This million dollars "made possible the purchase of a controlling interest in Interstate Equities Corporation, a management investment trust owning a representative list of securities, including common stock, preferred stocks and bonds." Was there any disclosure here that this controlling interest was purchased from you, Mr. Groves, at \$1,325,000?

A. Not in the words you have read there.

Q. In any words?

A. I don't know.

Q. Will you look at this annual report—

A. It doesn't do me any good to look at it. I can't add to the printed words.

Q. Is there any disclosure in the annual report which refers to the million dollars which you contributed to Chain & General Equities which in the remotest degree indicates that the \$1,325,000 of Interstate Equities stock was purchased from you?

A. No. I see nothing there—not there, it doesn't say anything.

<sup>67</sup> Id., Commission's Exhibit No. 9.

<sup>68</sup> Ibid.

<sup>69</sup> Derived from supplementary information supplied the Commission by The Equity Corporation.

<sup>70</sup> Op. cit. supra, note 1. Commission's Exhibit No. 19.

<sup>71</sup> Id., at 151-2.

## **F. Use of Funds Received by Wallace Groves from Sale of Interstate Equities Corporation Stock to Chain & General Equities, Inc. to Acquire Yosemite Holding Corporation**

It has been shown that Mr. Groves purchased the controlling block of common stock of Interstate Equities Corporation from Bancamerica-Blair Corporation in the early part of October 1931, with the approximately \$813,000 borrowed from Franklin Plan Corporation. Mr. Groves then "borrowed" approximately \$940,000 from Interstate Equities Corporation to pay for the controlling block of common stock of Chain & General Equities, Inc. Immediately after this payment to Chain & General Equities, Inc., he sold to that investment company his block of Interstate Equities stock, which had cost him approximately \$963,000 for approximately \$1,325,000, with a net profit of \$270,000 after deducting expenses.

Wallace Groves then proceeded to consummate his acquisition of control of Yosemite Holding Corporation, the third company in his plan, with the proceeds of his sale of the controlling block of common stock of Interstate Equities Corporation to Chain & General Equities, Inc.

On October 7, 1931, Wallace Groves had agreed to purchase directly from Yosemite Holding Corporation<sup>72</sup> 282,500 shares of its authorized but unissued common stock at \$1 per share for a total of \$282,500.<sup>73</sup> The agreement required an immediate payment of \$5,000 and the payment of the balance on November 2, 1931,<sup>74</sup> when the directors and officers of Yosemite Holding Corporation and at least a majority of the directors of its subsidiary investment company, Joint Investors, Inc., were to resign and the nominees of Mr. Groves were to be elected to the vacancies created.<sup>75</sup> Although the amount of stock to be purchased by Mr. Groves directly from Yosemite Holding Corporation constituted only 43% of Yosemite's voting stock, it was sufficient to give him working control of the company.<sup>76</sup> This was particularly so in view of the fact that Joint Investors, Inc., controlled by Yosemite Holding Corporation, in turn held 50,000 shares of Yosemite common stock or over 7% of the voting power of this company.<sup>77</sup> On the same day, October 7, 1931, Mr. Groves had

<sup>72</sup> Yosemite Holding Corporation, incorporated in Delaware on November 8, 1929, under the sponsorship of the Detroit firms of Baker, Simonds & Company, and Fidelity Trust Company, had suffered a severe shrinkage of assets. Its assets as at August 28, 1930, with security holdings computed at market or net asset values, aggregated \$1,057,677.65, and had depreciated by September 30, 1931, to \$313,960.00, a decline of 70%. (Id., at 1367, and Commission's Exhibits Nos. 28 and 31; and derived from supplementary information supplied the Commission by The Equity Corporation.) By September 30, 1931, \$95,656.00 had been returned to stockholders as the result of the repurchase of 2,502 shares of preferred stock for which the company originally received \$127,602.00 from the stockholders. (Derived from supplementary information supplied the Commission by The Equity Corporation.)

<sup>73</sup> Op. cit. supra, note 1, Commission's Exhibit No. 28.

<sup>74</sup> Ibid.

<sup>75</sup> Ibid.

<sup>76</sup> Id., Commission's Exhibits Nos. 28 and 185.

<sup>77</sup> Joint Investors, Inc., had been organized on January 11, 1926, by Grover O'Neill & Co., of New York. Yosemite Holding Corporation held 20,000 shares of the Class A stock and 20,000 shares of the Class B stock of Joint Investors, Inc., representing 41% of the voting power of Joint Investors, Inc. (Id., at 738, and Commission's Exhibits Nos. 28 and 208; *Moody's Manual of Investments, Banks, etc.*, 1932, p. 2212.)

agreed to purchase from Baker, Simonds & Company, the co-sponsor of Yosemite Holding Corporation, 254,394 warrants to subscribe to Yosemite stock at 20¢ per warrant, for an aggregate of \$50,878.80.<sup>78</sup> Payment for these warrants, which were valueless, was not to be made until November 5, 1931.<sup>79</sup>

Mr. Groves, as in his purchases of the controlling blocks of stock of Interstate Equities Corporation and Chain & General Equities, Inc., paid a premium for the controlling block of common stock of Yosemite Holding Corporation. On September 30, 1931, one week before Mr. Groves contracted to acquire control of the Yosemite Holding Corporation, the company possessed net assets of \$313,960.<sup>80</sup> The 377,199 shares of Yosemite common stock then outstanding had a net asset value of 17¢ per share.<sup>81</sup> In purchasing 282,500 shares from the company at \$1 per share, Mr. Groves was adding \$282,500 to the Yosemite Holding Corporation's assets. The 659,699 shares of Yosemite common stock that were outstanding after Mr. Groves met his commitment possessed a net asset value of 53¢ per share. Thus the 282,500 shares which Mr. Groves acquired possessed an aggregate net asset value of \$149,725 after the transaction was completed. The cost of these shares to Mr. Groves was \$282,500, or \$132,775 over the net asset value of the stock after payment. The premium paid for control of Yosemite Holding Company thus amounted to 89%. Stated differently, Mr. Groves had agreed to contribute about \$280,000 to acquire control over an additional \$315,000 of the net assets of Yosemite Holding Corporation.<sup>82</sup>

Control of Yosemite Holding Corporation was acquired directly from the company. Since preemptive rights were eliminated by a provision in the charter, it was unnecessary to make a prior offering to stockholders.<sup>83</sup> The transfer of control to Mr. Groves was thus facilitated. Disclosure of the sale to Mr. Groves was not made to stockholders until after it had been consummated.<sup>84</sup>

On November 2, 1931, the date fixed for the payment of the balance of \$277,500 for the Yosemite controlling block of stock, Mr. Groves, it will be recalled, had submitted to Chain & General Equities, Inc. his first proposal to sell to it the working control block of stock of Interstate Equities Corporation but had withdrawn the offer the same day, evidently after Mr. Byers in his memorandum criticized

<sup>78</sup> Op. cit. supra, note 1, at 242-5. The warrants entitled the holders thereof to purchase Yosemite Holding Corporation common stock at \$7 per share until December 1, 1934, and at \$10 per share thereafter to December 1, 1939. (Id., Commission's Exhibit No. 28.)

<sup>79</sup> Since Yosemite common stock had an asset value at the time of 17¢ per share, the warrants were valueless. (Op. cit. supra, note 1, Commission's Exhibits Nos. 28 and 185.) Apparently they were purchased to insure their cancelation. The sponsors acted as agents for all holders of warrants and were not selling for their own account. (Id., at 245.)

<sup>80</sup> Op. cit. supra, note 1, Commission's Exhibit No. 28.

<sup>81</sup> Ibid.

<sup>82</sup> Mr. Groves paid a premium of \$1,849,930 over the asset values of the stocks purchased from Interstate Equities Corporation, Chain & General Equities, Inc., and Yosemite Holding Corporation in order to acquire control over the assets of these investment companies aggregating \$10,928,468. The amount of this premium does not include the sum paid for the valueless Yosemite Holding Corporation stock warrants or for commissions, finders' fees, legal fees, and other expenses, aggregating over \$160,000. (See Appendix B, infra.)

<sup>83</sup> Op. cit. supra, note 1, Commission's Exhibit No. 185.

<sup>84</sup> Id., Commission's Exhibit No. 30.



the price. Consequently, on November 2, 1931, Mr. Groves had not obtained funds to pay for the Yosemite Holding Corporation stock. He remained in default on his contract to pay for this stock until November 5, 1931, the day after he sold the controlling block of stock of Interstate Equities Corporation to Chain & General Equities, Inc. for \$1,325,034. On that date he paid Yosemite Holding Corporation the \$277,500 remaining due on the Yosemite Holding Corporation common stock and took delivery of the securities.<sup>85</sup> Thus Mr. Groves acquired control of 43% of the voting power of Yosemite Holding Corporation, which in turn had working control of Joint Investors, Inc., which in turn held an additional 7% of the voting power of Yosemite Holding Corporation.

Wallace Groves immediately assumed control of the management of Yosemite Holding Corporation. On November 5, 1931, he caused the resignation of eight directors out of fourteen members of the board.<sup>86</sup>

Their places were taken by Wallace Groves and his nominees, Clifford B. Ewart, Wilfred S. Robinson, Ernest B. Warriner, William A. Brophy, Samuel C. Taylor, Albert A. Sommerwerck, and Franklin W. Ryan.<sup>87</sup> Mr. Groves' nominees also became the principal officers of the company. Messrs. Ewart, Ryan, Warriner, and Brophy were elected, respectively, president, vice president, secretary, and treasurer of the company. The new executive committee was composed of Messrs. Groves, Ewart, and Vance.<sup>88</sup>

#### **G. Fulfillment by Wallace Groves of Personal Obligations With Funds Received From Controlled Companies**

It will be recalled that on November 4, 1931, Mr. Groves had sold the control block of stock of Interstate Equities Corporation to Chain & General Equities, Inc. for \$1,325,034.<sup>89</sup> On that day, Mr. Groves' obligations in connection with the purchase of the controlling

<sup>85</sup> *Id.*, at 257.

<sup>86</sup> The 8 representatives of the retiring management were Luther D. Thomas, Richard W. Thomas, Robert Gair, Jr., Henry E. Riggs, F. W. ter Meulen, Jefferson Wheeler Baker, H. Bartow Farr, and John D. Wing. (Op. cit. supra, note 1, Commission's Exhibit No. 31.) The remaining representatives of the retiring management were Messrs. Lee W. Maxwell, Ray Vance, Thomas S. Clayton, Ralph W. Simonds, George E. Dyke, and Charles F. Kettering. (*Id.*, Commission's Exhibit No. 30.)

<sup>87</sup> Derived from supplementary information supplied the Commission by The Equity Corporation. All of these men, with the exception of Messrs. Sommerwerck and Ryan, had been elected directors of Chain & General Equities, Inc., the day before. (*Ibid.*) In addition Messrs. Ewart, Brophy, Taylor, and Sommerwerck were directors and/or officers of Franklin Plan Corporation. (Op. cit. supra, note 1, Commission's Exhibit No. 34.)

Mr. Kettering, then vice president of General Motors Corporation, testified that he was not merely an inactive director, but that he had been elected without his knowledge. (*Id.*, at 1460-2.) Mr. Dyke had received a commission from Mr. Groves for services in connection with his acquisition of Yosemite Holding Corporation. (*Id.*, at 254.) Messrs. Clayton and Simonds were representatives, respectively, of Fidelity Bank & Trust Company, and Baker, Simonds & Company, the original co-sponsors of Yosemite Holding Corporation. (*Id.*, Commission's Exhibit No. 30.) The record reveals no connection between Mr. Groves and Messrs. Vance and Maxwell.

<sup>88</sup> Derived from supplementary information supplied the Commission by The Equity Corporation.

<sup>89</sup> On November 4, 1931 Chain & General Equities, Inc. made partial payment of \$950,000 to Mr. Groves; on November 5, 1931 Chain & General Equities, Inc., paid Mr. Groves \$206,200, and on November 9, 1931 the balance of \$168,834. (Derived from supplementary information supplied the Commission by The Equity Corporation.)



blocks of all the investment companies totaled approximately \$2,241,000. He was committed to repurchase from Interstate Equities Corporation 467,938 shares of the common stock of Chain & General Equities, Inc. for approximately \$940,000 by November 14, 1931. Mr. Groves, it will be recalled, had utilized the \$940,000 paid to him for the Chain & General stock by Interstate Equities Corporation in order to buy this controlling block of stock directly from Chain & General Equities, Inc.<sup>90</sup> In addition, Mr. Groves still owed approximately \$813,000 to Franklin Plan Corporation, which money was used by Mr. Groves to acquire control of Interstate Equities Corporation. He was also obligated to pay Hunter Marston \$145,000 for 100,000 shares of Interstate Equities common stock which was included in the block of Interstate Equities common stock sold by Mr. Groves to Chain & General Equities, Inc., and to pay Baker, Simonds & Company, one of the original sponsors of Yosemite Holding Corporation, approximately \$50,000 for Yosemite Holding Corporation warrants. In addition, he was obligated to pay Interstate Equities Corporation \$18,000 for 12,000 shares of Interstate Equities common stock which he had contracted to purchase on October 14, 1931. Finally, on November 4, 1931 he was already two days in default on his obligation to pay Yosemite Holding Corporation \$277,500, the balance due for the 282,500 shares of common stock of Yosemite Holding Corporation.<sup>91</sup> Mr. Groves utilized the \$1,325,034 he had received on the sale of Interstate Equities common stock to Chain & General Equities, Inc. to meet the more immediate of these obligations. On November 5, 1931, Mr. Groves paid \$50,878.80 to Baker, Simonds & Company for 254,394 Yosemite Holding Corporation warrants<sup>92</sup> and paid \$277,500 representing the balance due to Yosemite Holding Corporation for the 282,500 shares of common stock of that company. On the same day he paid \$145,000 to Hunter Marston, the balance due for 100,000 shares of the common stock of Interstate Equities Corporation. He was also in a position to pay his obligation to Franklin Plan Corporation amounting to \$813,000. He still had the obligation, however, to repurchase the Chain & General Equities, Inc. stock from Interstate Equities Corporation for \$940,000. The method by which he satisfied this obligation will now be indicated.

#### **H. Use of Funds of Yosemite Holding Corporation to Repay "Loan" to Interstate Equities Corporation—Sale by Wallace Groves of Stock of Chain & General Equities, Inc. to Yosemite Holding Corporation**

Mr. Groves used the \$1,325,034, the proceeds of the sale of the common stock of Interstate Equities Corporation to Chain & General Equities, Inc., to fulfill commitments other than the repurchase of the Chain & General stock from Interstate Equities Corporation.<sup>93</sup> It was essential for Mr. Groves to find another source of funds to effect this repurchase. This source was Yosemite Holding Corporation, the newly acquired investment company.

<sup>90</sup> Op cit. supra, note 1, Commission's Exhibit No. 11.

<sup>91</sup> Id., at 249-50.

<sup>92</sup> Id., at 257.

<sup>93</sup> Id., at 250.

On November 5, 1931, Mr. Groves had obtained voting control of Yosemite Holding Corporation and had installed his nominees in a majority of positions on the board of directors. Six days later, on November 11, 1931, the new board passed a resolution rescinding all prior resolutions prohibiting the officers and directors of Yosemite Holding Corporation from dealing with the company as principal or agent.<sup>94</sup> Immediately after the passage of this resolution the board approved a contract between the company and Mr. Groves pursuant to which the company assumed almost half of his obligation to Interstate Equities Corporation to repurchase the Chain & General common stock.<sup>95</sup>

This agreement, after reciting that Mr. Groves had the right to purchase 467,938 shares of the common stock of Chain & General Equities, Inc. from Interstate Equities Corporation, provided that he would cause to be sold to Yosemite Holding Corporation 231,158 of such shares at \$2.38 per share for a total of \$550,000.<sup>96</sup> Yosemite Holding Corporation was to make payment for and receive delivery of the stock two days later, November 13, 1931.<sup>97</sup> Thus, one week after Mr. Groves had purchased the common stock of Chain & General Equities, Inc., allegedly for a "long term investment,"<sup>98</sup> he sold approximately one-half of his holdings of that stock to Yosemite Holding Corporation, also controlled by him.<sup>99</sup>

# 1. LIQUIDATION OF PORTFOLIO BY YOSEMITE HOLDING CORPORATION TO RAISE MONEY TO PURCHASE STOCK OF CHAIN & GENERAL EQUITIES, INC. FROM WALLACE GROVES

Yosemite Holding Corporation did not have cash sufficient to make this payment of \$550,000. It possessed only \$24,054.83 in cash as at September 30, 1931.<sup>100</sup> Consequently, on November 12, 1931, the day after Yosemite Holding Corporation agreed to purchase the stock of Chain & General Equities, Inc. from Wallace Groves, its controlling stockholder, the new board of directors sold the major portion of the company's general portfolio, consisting mostly of marketable securities, to raise the necessary money.<sup>101</sup> Securities

<sup>94</sup> Derived from supplementary information supplied the Commission by The Equity Corporation. The directors present at this meeting were Messrs. Ewart, Robinson, Brophy, Warriner, Ryan, Taylor, Sommerwerck, Maxwell, Vance, and Dyke. (Ibid.) All but Messrs. Maxwell, Vance, and Dyke were nominees of Mr. Groves. (Ibid.)

<sup>95</sup> Derived from supplementary information supplied the Commission by The Equity Corporation.

<sup>96</sup> Op. cit. supra, note 1, Commission's Exhibit No. 32. An option on an additional 125,000 shares of Chain & General Equities, Inc. common stock, exercisable at the same price until February 1, 1932, was granted to Yosemite Holding Corporation and/or Joint Investors, Inc., its controlled company. (Ibid.) The agreement also gave Mr. Groves the option of purchasing up to 100,000 additional shares of Yosemite Holding Corporation common stock at \$1.00 per share up to November 15, 1932. (Ibid.)

<sup>97</sup> Op. cit. supra, note 1, Commission's Exhibit No. 32.

<sup>98</sup> Id., at 258-9.

<sup>99</sup> The manner in which Mr. Groves disposed of the balance of the stock of Chain & General Equities, Inc. is discussed infra.

<sup>100</sup> Op. cit., supra, note 1, Commission's Exhibit No. 28.

<sup>101</sup> Id., at 791-6, 797.

which had cost Yosemite Holding Corporation and Union Investors, Inc., another Yosemite Holding Corporation subsidiary,<sup>102</sup> \$508,750.59 were liquidated in one day for \$321,138.10 at an aggregate loss of \$187,612.49.<sup>103</sup> After this liquidation and the purchase of Chain & General Equities, Inc. stock from Mr. Groves, the assets of Yosemite Holding Corporation consisted almost entirely of its holdings in Joint Investors, Inc. and Chain & General Equities, Inc.<sup>104</sup> When questioned on this phase of his dealings with Yosemite Holding Corporation, Mr. Groves testified:<sup>105</sup>

Q. Now, isn't it a fact that \* \* \* "they" [the board of directors of Yosemite Holding Corporation] sold every single security that they had in the portfolio except the Joint Investors stock that they owned and the Chain & General stock that they owned in order for them to raise the cash to buy from you the Chain & General stock?

A. They sold the greater portion of them.

Q. \* \* \* didn't "they" clean out the portfolio to buy the Chain & General stock from you?

A. I told you they sold a good deal of it, or most all of it. I don't know about it.

Q. So that on December 31, 1931, they only had Joint Investors stock and Chain & General stock, every share of which came from you, isn't that so, Mr. Groves?

A. Yes.

This \$321,138.10 raised by Yosemite Holding Corporation on November 12, 1931, by the liquidation of its securities, together with the \$282,500 derived by Yosemite Holding Corporation from the sale to Wallace Groves of its unissued common stock was used by Yosemite Holding Corporation to purchase the 231,158 shares of Chain & General stock from Mr. Groves. Yosemite Holding Corporation made payment on November 16, 1931, three days after the due date.<sup>106</sup> The acquisition of this block of Chain & General stock gave Yosemite Holding Corporation approximately 35% of the total voting power of Chain & General Equities, Inc.<sup>107</sup> Subsequently, Mr. Groves caused Yosemite Holding Corporation to increase its holdings of Chain & General stock until by June 30, 1932 Yosemite possessed over 50% of the total voting power of Chain & General Equities, Inc., as will be indicated.<sup>108</sup>

<sup>102</sup> Id., Commission's Exhibit No. 28. Union Investors, Inc. was a wholly-owned subsidiary investment company of Yosemite Holding Corporation, which had merged with Yosemite Holding Corporation. (Id., at 799.)

<sup>103</sup> Id., at 798-800, and Commission's Exhibit No. 106. Securities costing Yosemite Holding Corporation \$269,011.85 were sold for \$150,023.15, a loss of \$118,988.70. Securities costing Union Investors, Inc., \$239,738.74 were sold for \$171,114.95, a loss of \$68,623.79. (Ibid.)

<sup>104</sup> Id., at 797. As at December 31, 1931, Yosemite Holding Corporation assets, in addition to the stock of Chain & General Equities, Inc., and Joint Investors, Inc., consisted of only \$41,624.99 in cash, \$4,374.53 in accrued interest and accounts receivable, \$3,375.57 in furniture and fixtures, \$510.10 in prepaid insurance premiums and securities costing \$23,574.14 but having an ascertainable market value of \$3,990. (Id., Commission's Exhibit No. 30.)

<sup>105</sup> Id., at 796-7.

<sup>106</sup> Derived from supplementary information supplied the Commission by The Equity Corporation. Mr. Groves' commitment to repurchase the stock of Chain & General from Interstate Equities Corporation matured on November 14, 1931, but he did not make actual payment until November 16, 1931. (Ibid.)

<sup>107</sup> For the purpose of election of directors, however, provision was made for cumulative voting. (Op. cit. supra, note 1, Commission's Exhibit No. 219.)

<sup>108</sup> Derived from supplementary information supplied the Commission by The Equity Corporation.

In causing the sale of the stock of Chain & General Equities, Inc., to Yosemite Holding Corporation, Mr. Groves followed the same procedure he had employed in "unloading"<sup>109</sup> the stock of Interstate Equities Corporation on Chain & General Equities, Inc. the previous week. Mr. Groves claimed that his so-called long term investment of \$282,500 in the Yosemite Holding Corporation stock on November 5, 1931, enriched the investment company to the extent of the cash paid into its treasury.<sup>110</sup> Eleven days later, however, on November 16, 1931, Mr. Groves had sold to Yosemite Holding Corporation 231,158 shares of Chain & General Equities, Inc. for \$550,000. Yosemite Holding Corporation, therefore, not only paid out the cash it had just received, but also liquidated practically its entire portfolio to raise the balance of the money needed to buy the Chain & General stock from Mr. Groves.

## 2. PAYMENT OF PREMIUM FOR CHAIN & GENERAL EQUITIES, INC. COMMON STOCK BY YOSEMITE HOLDING CORPORATION

As has been previously shown, on November 4, 1931 Mr. Groves sold to Chain & General Equities, Inc., then under his control, 642,517 shares of the common stock of Interstate Equities Corporation at a substantial premium over its asset value and at a net profit to himself of \$271,069.72. This sale was admitted by Paul H. Byers, one of Mr. Groves' nominees to the board of directors of Chain & General Equities, Inc., to be an "unloading."<sup>111</sup> The sale of the 231,158 shares of Chain & General Equities, Inc. stock to Yosemite Holding Corporation was of a similar nature.

At the time of this sale Mr. Groves had voting control of Yosemite Holding Corporation and a majority of the directors were his nominees. That the directors were aware of the self-dealing involved in the sale is indicated by their action in rescinding all resolutions prohibiting transactions between the company and a director as principals on November 11, 1931.<sup>112</sup>

In selling to the company for a total of \$550,000 the 231,158 shares of the common stock of Chain & General Equities, Inc. for which he had paid only \$2.00 per share, Mr. Groves made a gross profit of \$87,684<sup>113</sup> and Yosemite Holding Corporation paid over a half million dollars for stock that had no asset value.<sup>114</sup>

In the opinion of Mr. Groves it was desirable that Yosemite Holding Corporation purchase the common stock of Chain & General Equities, Inc., as a "leverage" security, in order to enable Yosemite Holding Corporation to recoup its past losses.<sup>115</sup> However, as at

<sup>109</sup> Op. cit. supra, note 1, Commission's Exhibit No. 12.

<sup>110</sup> Id., at 246.

<sup>111</sup> Id., Commission's Exhibit No. 30.

<sup>112</sup> Derived from supplementary information supplied the Commission by The Equity Corporation.

<sup>113</sup> Op. cit. supra, note 1, at 267, and Commission's Exhibits Nos. 8 and 11.

<sup>114</sup> Id., Commission's Exhibits Nos. 9 and 19. (See also note 46, supra.) Yosemite Holding Corporation stated the market value of the Chain & General common was \$277,686.58, but Mr. Groves conceded that the over-the-counter market in which the common stock of Chain & General was traded was only a nominal one. (Id., at 291-2, and Commission's Exhibit No. 30.)

<sup>115</sup> Op. cit. supra, note 1, at 263-4.

December 31, 1931, the Chain & General common stock was without asset value and the preferred stock of Chain & General Equities, Inc. was \$14.50 per share "under water" on the basis of par value and taking into account dividends in arrears.<sup>116</sup> Since there were then outstanding 25,513 shares of the preferred stock of Chain & General Equities, Inc., the assets of Chain & General Equities, Inc. would have had to increase by \$370,019.12 before the asset value of the Chain & General preferred stock would reach its par figure plus unpaid dividends.<sup>117</sup> At this time, there were also outstanding 627,200 shares of Chain & General Equities, Inc. common stock.<sup>118</sup>

For these shares to reach an asset value of \$2.38 per share, which was the cost to Yosemite Holding Corporation, the assets of Chain & General Equities, Inc. would have had to increase in value an additional \$1,492,736. In other words, a total increase of \$1,862,755.12<sup>119</sup> or an 80% increase in the value of the assets of Chain & General Equities, Inc. would have been necessary to cover the preferred stock and bring the common stock up to the price paid by Yosemite Holding Corporation. No increase ever materialized. When Yosemite Holding Corporation was finally dissolved in January 1934, more than two years later, its holdings of the common stock of Chain & General Equities, Inc. were liquidated at a substantial loss.<sup>120</sup>

### 3. NONDISCLOSURE TO STOCKHOLDERS OF YOSEMITE HOLDING CORPORATION OF TRANSFER OF CONTROL

The directors of Yosemite Holding Corporation failed to make adequate or timely disclosure to their stockholders of the more significant aspects of the management of the company. Thus, disclosure of the retirement of the original sponsors from the management of the company and the transfer of control to Wallace Groves was not made until December 31, 1931, seven weeks after the transfer had been effected.<sup>121</sup>

The letter of the president of Yosemite Holding Corporation accompanying the report to stockholders for the period ending December 31, 1931 stated that Yosemite Holding Corporation had made a substantial investment in the common stock of Chain & General Equities, Inc. but failed to reveal that the purchase had been made from Wallace Groves, the dominant figure in the new management of the company, and failed to reveal the amount of his profit. Likewise, the letter did not disclose that the bulk of the company's marketable securities had been liquidated in order to raise money for the purchase of the block of Chain & General stock from Mr.

<sup>116</sup> Id., Commission's Exhibit No. 19. Figured on another basis the preferred stock was even further "under water," to the extent of \$29.50. This figure represents the difference between the amount each preferred shareholder would have been entitled to on voluntary liquidation (\$115) plus accrued dividends (\$5.21) and the amount of assets available for the preferred stock (\$90.71). (Id., Commission's Exhibit No. 19 and supplementary information supplied the Commission by The Equity Corporation.)

<sup>117</sup> Op. cit. supra, note 1, Commission's Exhibit No. 19.

<sup>118</sup> Ibid.

<sup>119</sup> Ibid.

<sup>120</sup> See discussion infra, pp. 223-4.

<sup>121</sup> Op. cit. supra, note 1, Commission's Exhibit No. 30.

Groves.<sup>122</sup> Mr. Groves conceded that disclosure of his connection with the purchase had not been made:<sup>123</sup>

Q. Is there any indication here, Mr. Groves, in connection with the announcement that you have acquired 282,500 shares of its common stock at a dollar a share, that immediately upon the payment for that 282,500 shares you sold the corporation 236,178 shares of Chain & General Equities for half a million dollars?

\* \* \* \* \*

A. Let me read it. (After examining the paper.) Yes; in the balance sheet they show the cost of it.

Q. But there is no disclosure that it was purchased from you?

A. I don't see any here, no.

## I. Use of Funds of Franklin Plan Corporation to Repay "Loan" to Interstate Equities Corporation

Mr. Groves, in order to meet his commitment to repurchase from Interstate Equities Corporation for approximately \$940,000 the 467,938 shares of Chain & General common stock, had thus arranged to sell 231,158 of such shares to his controlled company, Yosemite Holding Corporation, for \$550,000. Yosemite Holding Corporation paid for the stock on November 16, 1931.<sup>124</sup> Mr. Groves still needed approximately \$470,000 to pick up the balance of the block of Chain & General stock from Interstate Equities Corporation. On the same day, November 16, 1931, Mr. Groves sold to Franklin Plan Corporation these remaining 236,780 shares of Chain & General common stock at \$2.40 per share, for a total of \$568,272, although they had no asset value at this time. The agreement also provided that Wallace Groves would repurchase these shares of stock at cost within ninety days.<sup>125</sup> As has been indicated, Franklin Plan Corporation was controlled by Wallace Groves and his brother, and had previously lent Mr. Groves the \$813,000 employed by him in purchasing control of Interstate Equities Corporation.

This purchase marked a wide deviation by Franklin Plan Corporation from its corporate purpose. Mr. Groves conceded that Franklin Plan Corporation, as a holding company for small loan companies, was not in the business of acquiring investment trusts:<sup>126</sup>

<sup>122</sup> Ibid.

<sup>123</sup> Id., at 290-1.

<sup>124</sup> See note 106, supra.

<sup>125</sup> Op. cit., supra, note 1, at 268, 271, 789, and Commission's Exhibits Nos. 19 and 33. See also note 46, supra. This repurchase provision in some respects was similar to the provision in the contract for the sale of Chain & General stock by Mr. Groves to Interstate Equities Corporation, which has been characterized as, in effect, a loan. (See discussion, supra, pp. 199-200.)

<sup>126</sup> Op. cit., supra, note 1, at 268-70. The board of directors of Franklin Plan Corporation was dominated by men friendly to Mr. Groves' interests. George Groves, William A. Brophy, Samuel C. Taylor, and Albert A. Sommerwerck, all nominees of Wallace Groves, constituted a majority of the board of Franklin Plan Corporation. (Id., Commission's Exhibit No. 34.) With the exception of George Groves, all of the men had already been designated by Wallace Groves as directors of Yosemite Holding Corporation and/or Chain & General Equities, Inc. (See notes 50, 51, and 87, supra.) Although Mr. Groves stated that the directors of Franklin Plan Corporation were desirous of participating in what seemed a "very fine deal," the transaction was opposed by every director of Franklin Plan Corporation other than the nominees of Mr. Groves. (Op. cit. supra, note 1, Commission's Exhibit No. 34.)

Q. \* \* \* What did you do with that 236,780 shares of the Chain & General Equities stock, Mr. Groves?

A. At some time thereafter I sold some part of it to Franklin Plan Corporation at cost.

Q. Franklin Plan Corporation—that was controlled by your brother; is that so?

A. Yes.

\* \* \* \* \*

Q. Now, the Franklin Plan Corporation didn't have any previous policy of acquiring investment trusts, did it, Mr. Groves?

A. To my knowledge, as I remember, as a director of the company, I don't think they did. I don't know. They had the theory, so they told me at the time, that the purchase being at cost, that practically all of the money going into the treasury of the company, and security prices being as low as they were, that it seemed I had made a very fine deal and they would like to get part of the stock.

As was the case in the sale by Mr. Groves of the 231,158 shares of Chain & General stock on November 16, 1931, to Yosemite Holding Corporation whereby Groves made a gross profit of \$87,684, the sale of the remainder of the block, 236,780 shares of Chain & General stock on the same day to Franklin Plan Corporation enabled Mr. Groves to realize a gross profit of \$94,712.<sup>127</sup> Mr. Groves, therefore, made a gross profit on his sale of the entire block of Chain & General Equities, Inc. of \$182,396.<sup>128</sup>

Thus Wallace Groves received a total of \$1,118,272 from Yosemite Holding Corporation and Franklin Plan Corporation on November 16, 1931.<sup>129</sup> On the same day he paid approximately \$940,000 of this money to Interstate Equities Corporation in fulfillment of his repurchase obligation and took delivery from Interstate Equities Corporation of the 467,938 shares of Chain & General common stock.<sup>130</sup> He immediately turned over to Yosemite Holding Corporation and Franklin Plan Corporation their respective portions of this block of stock.

## J. Consummation of Acquisition

After Mr. Groves repaid his "loan" to Interstate Equities Corporation on November 16, 1931, he was assured of direct or indirect control of three investment companies. His direct and indirect holdings of 342,500 shares of the common stock of Yosemite Holding Corporation constituted slightly over 50% of the voting power of that company.<sup>131</sup> Yosemite Holding Corporation, together with Franklin Plan Corporation controlled by himself and his brother, George Groves, held 468,438 shares<sup>132</sup> of the common stock of Chain & General Equities, Inc., representing approximately 72% of the voting

<sup>127</sup> Op. cit., supra, note 1, Commission's Exhibits Nos. 8, 11 and 33.

<sup>128</sup> Mr. Groves claimed that expenses reduced the amount of profit, but was unable to supply any details. (Id., at 281.)

<sup>129</sup> Op. cit. supra, note 1, Commission's Exhibit No. 33, and derived from supplementary information supplied the Commission by The Equity Corporation.

<sup>130</sup> See note 106, supra.

<sup>131</sup> Op. cit. supra, note 1, Commission's Exhibits Nos. 30 and 185. Mr. Groves held directly 292,500 shares of Yosemite common stock, having purchased an additional 10,000 shares for \$10,000 from Yosemite Holding Corporation on November 6, 1931. Indirectly, through Joint Investors, Inc., he held another 50,000 shares. (Derived from supplementary information supplied the Commission by The Equity Corporation.)

<sup>132</sup> This amount includes 500 shares acquired by Yosemite Holding Corporation from the portfolio of Union Investors, Inc., a subsidiary.



power of that company.<sup>133</sup> Finally, Chain & General Equities, Inc., held 702,517 shares of Interstate Equities Corporation common stock, or approximately 50% of the company's voting power.<sup>134</sup>

Yosemite Holding Corporation, Chain & General Equities, Inc., and Interstate Equities Corporation, were now pyramided one upon the other with the top company controlled by Wallace Groves, with gross assets (unconsolidated) of approximately \$14,000,000 as of December 31, 1931.<sup>135</sup> Mr. Groves testified:<sup>136</sup>

Q. Well, do you know what were the total assets of those three corporations?

A. \* \* \* eleven or twelve million dollars.

Q. Which you got control of in payment of \$282,000?

A. My total investment in Yosemite Holding Corporation was nearer to \$400,000.

Q. Well, I will assume it was \$400,000; but from the investment of \$400,000, you had controlled, or you had the control, of assets of more than \$10,000,000?

A. That is correct, sir.

Q. And you accomplished that purpose by selling the securities of the under company to the over company at the time you put your nominee on the board of directors? Isn't that so?

A. You have brought out the fact, sir. I can't answer that yes or no.

Although Mr. Groves' gross investment in Yosemite Holding Corporation aggregated \$400,000, the record indicates that the net cost to him of such investment was nominal.<sup>137</sup>

#### K. Attempted Use of Funds of Joint Investors, Inc. to Meet Obligation to Franklin Plan Corporation

Mr. Groves' program of expansion was now almost complete. However, he still had the personal obligation to repurchase the 236,780 shares of Chain & General stock for \$568,272 from Franklin Plan Corporation within ninety days after he had sold this stock to Franklin Plan Corporation.<sup>138</sup> Mr. Groves failed to meet this commitment out of his personal resources but sought other investment companies to assume the burden of his obligation. He first attempted to unload this obligation on Joint Investors, Inc., one of his indirectly controlled companies.

Yosemite Holding Corporation, after it had purchased 231,158 shares of Chain & General stock (approximately one-half the block

<sup>133</sup> Op. cit. supra, note 1, Commission's Exhibits Nos. 19, 30, 33, and 219. Voting for directors was cumulative. (Id., Commission's Exhibit No. 219.) Yosemite held 231,658 shares, or 35.5%, and Franklin Plan Corporation held 236,780 shares, or 36.3% of the voting power of Chain & General Equities, Inc.

<sup>134</sup> Op. cit. supra, note 1, Commission's Exhibits Nos. 2, 18, and 19.

<sup>135</sup> Id., Commission's Exhibits Nos. 18, 19, and 30. In making this calculation, securities in the general portfolios were taken at market or assigned values, rather than at cost. Yosemite's holdings in Chain & General Equities, Inc., and Chain & General's investment in Interstate Equities Corporation were taken at asset values. (Ibid.) Thus, Yosemite Holding Corporation had gross assets of \$62,806.83; Chain & General's gross assets aggregated \$2,323,055.76; Interstate Equities' gross assets totaled \$11,630,776.21. (Ibid.) The figures on Interstate Equities Corporation were taken as of October 20, 1931, because no balance sheet for the year-end was available.

<sup>136</sup> Op. cit. supra, note 1, at 281-2.

<sup>137</sup> The computation showing the cost of these acquisitions to Mr. Groves is given in detail in Appendix B, p. 781.

<sup>138</sup> Op. cit. supra, note 1, at 271, 789, and Commission's Exhibit No. 33.



that Groves was required to repurchase from Interstate Equities Corporation) for \$550,000, did not have the funds to repurchase the remainder of the block of Chain & General stock from Franklin Plan Corporation.<sup>139</sup> However, at the end of November 1931, Yosemite Holding Corporation had voting control of Joint Investors, Inc., an investment company possessing, as of December 31, 1931, net assets of \$638,298.<sup>140</sup>

In addition to possessing voting control of Joint Investors, Inc., Mr. Groves had installed his nominees on the board of directors of Joint Investors, Inc. On November 5, 1931, the day on which Mr. Groves had assumed control of Yosemite Holding Corporation, Mr. Groves and his nominees, Messrs. Clifford B. Ewart, Ernest B. Wariner, Wilfred S. Robinson, William A. Brophy, Samuel C. Taylor and Albert A. Sommerwerck were elected to seven of the eleven positions on the board of directors of Joint Investors, Inc.<sup>141</sup>

Wallace Groves proposed to Grover O'Neill, original sponsor of Joint Investors, Inc., who was still a director of the company, that Joint Investors, Inc. purchase from him, Mr. Groves, 100,000 shares of Chain & General common stock at \$2.30 per share for a total of \$230,000.<sup>142</sup> These shares were part of the 236,780 shares which Mr. Groves had agreed to repurchase from Franklin Plan Corporation. As an alternative Mr. Groves proposed that Joint Investors, Inc. lend Yosemite Holding Corporation the \$230,000 with which to make the purchase and take an option on the stock exercisable at the

<sup>139</sup> Yosemite Holding Corporation had liquidated almost its entire portfolio on November 12, 1931, in order to raise money to purchase 231,158 shares of the common stock of Chain & General Equities, Inc. from Mr. Groves. As of December 31, 1931, it possessed net assets of only \$52,907.38, evaluating its general portfolio at market and its investments in subsidiaries' stock at liquidating value. (Id., Commission's Exhibits Nos. 19 and 30.)

<sup>140</sup> In computing the net assets of Joint Investors, Inc., portfolio securities were taken at market value. (*Kane's Manual of Investment Trusts*, 1932, p. 1378.) Joint Investors, Inc., had been organized by Grover O'Neill, partner in Grover O'Neill & Company, on January 11, 1926. At the time Mr. Groves acquired control of Yosemite Holding Corporation, Yosemite held 20,000 shares of each of the Class A and Class B stocks of Joint Investors, Inc., representing working control of that company. On November 13, 1931, Yosemite Holding Corporation had acquired an additional 10,000 shares of the Class B stock, thus obtaining voting control of Joint Investors, Inc. (Op. cit. supra, note 1, at 738, 743-5, 1577, and Commission's Exhibits Nos. 28, 30; and derived from supplementary information supplied the Commission by The Equity Corporation.)

<sup>141</sup> Op. cit. supra, note 1, at 478, and supplementary information supplied the Commission by The Equity Corporation. On the same day these men had been elected to a majority of the positions on the board of Yosemite Holding Corporation. (Ibid.) The installation of Mr. Groves' nominees on the boards of Yosemite Holding Corporation and Joint Investors, Inc. was affected in accordance with the agreement of October 7, 1931, between Mr. Groves and Yosemite Holding Corporation which provided for the sale of Yosemite Holding Corporation to Mr. Groves.

<sup>142</sup> On November 11, 1931, when Yosemite Holding Corporation agreed to purchase from Mr. Groves 231,158 shares of Chain & General Equities, Inc., common stock at \$2.38 per share (op. cit. supra, note 1, Commission's Exhibit No. 32) the agreement also accorded an option to Yosemite Holding Corporation and/or Joint Investors, Inc., to purchase up to 125,000 additional shares of Chain & General common stock at the same price. This option was exercisable up to February 1, 1932. (Ibid.) On November 12, 1931, the day after the execution of the contract with Mr. Groves, the directors of Yosemite Holding Corporation decided to release Yosemite Holding Corporation's interest in the option to the extent that Joint Investors, Inc. would exercise it. (Derived from supplementary information supplied the Commission by The Equity Corporation.)

same price for three years.<sup>143</sup> Although Mr. O'Neill pointed out that such a transaction would constitute a violation of the by-laws of Joint Investors, Inc., Mr. Groves insisted that the deal was perfectly proper. Mr. O'Neill testified in this connection as follows:<sup>144</sup>

A. \* \* \* I have pointed out to Mr. Groves, article 4, section 6 of our bylaws as follows:

"The corporation may contract for any lawful purpose with one or more of its directors or with any corporation having with it a common director or directors, if the contract is entered into in good faith and is approved or ratified by a majority vote at any meeting of its Board of Directors, providing the director or common director or directors shall not vote on the question and shall not be counted in ascertaining whether or not a quorum is present for the purpose of the meeting. However, no director, officer, or employee of this company may deal as principal with this corporation in the purchase or sale of securities for the account of the corporation; nor may any such director, officer, or employee, either directly or indirectly, loan to this corporation or borrow from this corporation money or securities. Nothing hereinabove contained shall be deemed to include or refer to shares of stock of this corporation or any securities it may issue from time to time."

Nevertheless, Mr. Groves felt and was advised by his attorney that it was entirely proper for Joint Investors to make such a loan provided the common directors did not vote thereon.

In order to have Joint Investors, Inc. make the purchase, Mr. Groves requested that a special meeting of the directors of Joint Investors, Inc. be called for the morning of February 1, 1932.<sup>145</sup> He expected Mr. O'Neill to obtain the consent of the other directors of Joint Investors, Inc.<sup>146</sup> However, on January 30, 1932, Mr. O'Neill informed Mr. Groves that he would not consent to the transaction because it was neither a sound investment<sup>147</sup> nor a "proper" one.<sup>148</sup>

According to Mr. O'Neill, Mr. Groves, however, attempted to coerce him, Mr. O'Neill, into approval of the deal by thinly veiled threats that the management contract which Mr. O'Neill held with Joint Investors, Inc. would be abrogated,<sup>149</sup> despite the fact that only a few weeks before Mr. Groves had proposed giving Mr. O'Neill a contract to manage Yosemite Holding Corporation as well as Joint Investors, Inc.<sup>150</sup> Mr. O'Neill testified that he informed Mr. Warriner, one of Mr. Groves' nominees, that he would regard such tactics as "crooked":<sup>151</sup>

<sup>143</sup> Op. cit. supra, note 1, at 758-9. At a special meeting of the directors of Yosemite Holding Corporation held January 28, 1932, its officers were authorized, in view of the fact that Yosemite Holding Corporation lacked funds to exercise its option to purchase Chain & General stock, to negotiate with Joint Investors, Inc. for a loan to Yosemite Holding Corporation of the necessary money. (Derived from supplementary information supplied the Commission by The Equity Corporation.)

<sup>144</sup> Op. cit. supra, note 1, at 758-9.

<sup>145</sup> Id., at 765.

<sup>146</sup> Id., at 765-6.

<sup>147</sup> The price of \$2.30 per share for Chain & General common stock represented an inordinately large premium over the net asset value of the stock. As of December 31, 1931, the net assets of Chain & General Equities, Inc., aggregated \$1,260,385.59 with its holdings of Interstate Equities Corporation common stock considered to be without value. (Id., Commission's Exhibit No. 19.) In order for the common stock of Chain & General Equities, Inc., to reach an asset value of \$2.30 per share—the proposed cost to Joint Investors, Inc.—the value of the assets of Chain & General Equities, Inc., would have had to increase by \$2,733,474, or an increase of about 215% over the existing value of its net assets. (Id., at 760 and Commission's Exhibit No. 19.)

<sup>148</sup> Op. cit. supra, note 1, at 766.

<sup>149</sup> Id., at 767-9.

<sup>150</sup> Id., at 754, 765.

<sup>151</sup> Id., at 767-8.

A. I received another call in which Mr. Warriner said that he would like to have me call a special meeting of the Board for Monday evening, for the purpose of examining into the management contract, that they had been looking into other services.

Q. That is, \* \* \* [after] you said that you weren't going to buy or approve the purchase \* \* \* of [the Chain &] General stock from Mr. Wallace Groves, \* \* \* he then said, "Well, we are going to call a meeting to see if there isn't something wrong in connection with your management contract," isn't that so, substantially?

A. I think that that is an inference.

\* \* \* \* \*

I developed the fact in talking with Mr. Warriner that he had just given me every reason to believe that they had confidence in my management and he admitted as much, and then I asked him why he brought up the question of management in that effect, that I thought that I understood what he was trying to do, and I said that I take it that you are endeavoring to force me to agree with you in the Chain & General Equities matter, and that I would regard such a transaction as crooked.

I said that my name and the names of my friends are connected with Mr. Groves in this and other companies, and I will not permit any action to be taken that will bring them into disrepute.

On February 25, 1932, Mr. O'Neill formed a protective committee of the preferred stockholders of Joint Investors, Inc. to oppose Mr. Groves.<sup>152</sup> When examined on Mr. O'Neill's resistance to the sale of Chain & General stock to Joint Investors, Inc., Mr. Groves testified:<sup>153</sup>

Q. And isn't it a fact the reason you couldn't sell the balance of that total commitment to Joint Investors was because Mr. Grover O'Neill resisted your attempt to unload that stock on that trust?

A. That is rather difficult to answer in the affirmative there, because we had—Yosemite had—several opportunities to sell their interest in cash.

Q. No, answer me, please: did you try to sell the balance of that stock to Joint Investors?

A. It was discussed.

Q. Did Mr. Grover O'Neill oppose it?

A. He didn't want to do it.

Shortly afterwards, relations between Yosemite Holding Corporation and Joint Investors, Inc., were severed. On March 18, 1932 the protective committee purchased from Yosemite Holding Corporation the latter's holding of 20,000 shares of the Class A and 30,000 shares of the Class B stock of Joint Investors, Inc., for \$120,000.00.<sup>154</sup>

### **L. Use of Funds of Yosemite Holding Corporation to Meet Wallace Groves' Obligation to Franklin Plan Corporation**

Wallace Groves had failed in his attempt to have Joint Investors, Inc., assume the burden of his repurchase commitment to Franklin Plan Corporation because of the opposition of Grover O'Neill. He was successful in his dealings with Yosemite Holding Corporation, where he met no opposition. On March 18, 1932, Yosemite Holding Corporation had realized \$120,000 from the sale of its holdings in

<sup>152</sup> Id., Commission's Exhibit No. 212, and supplementary information supplied the Commission by The Equity Corporation.

<sup>153</sup> Op. cit. supra, note 1, at 262.

<sup>154</sup> Id., at 775, 778. Yosemite Holding Corporation used \$15,000 of this sum to repurchase from Joint Investors, Inc. 3,200 shares of Chain & General common stock and 50,000 shares of Yosemite Holding Corporation common stock. (Id., at 779 and derived from supplementary information supplied the Commission by The Equity Corporation.)

Joint Investors, Inc. Six days later, on March 24, 1932, Yosemite Holding Corporation used \$99,436.40 of that sum in exercising its option to purchase from Mr. Groves 41,780 shares of the common stock of Chain & General Equities, Inc., at \$2.38 per share. Simultaneously Mr. Groves repurchased the same number of shares from Franklin Plan Corporation at \$2.40 per share.<sup>155</sup>

### **M. Acquisition of Granger Trading Corporation and Use of Its Funds to Meet Obligation to Franklin Plan Corporation**

Mr. Groves, therefore, had had only partial success in causing his controlled investment companies to meet his repurchase commitment with Franklin Plan Corporation. After March 24, 1932, he was still obligated to reacquire 195,000 shares of Chain & General common stock from Franklin Plan Corporation. Since Yosemite Holding Corporation had no substantial assets and the attempted sale of Chain & General stock to Joint Investors, Inc. had been prevented by a protective committee, Mr. Groves sought a new source of funds.

In the early part of 1932 Mr. Groves, on behalf of Yosemite Holding Corporation, began negotiations with Jeffrey Granger, president of Granger Trading Corporation,<sup>156</sup> still another investment company, with the ostensible purpose of making Granger Trading Corporation the "nucleus" or "basis" of a larger trust. Mr. Granger testified:<sup>157</sup>

\* \* \* I understood Mr. Groves was going to use my trust as the basis of a much larger trust. In other words, I understood that there was going to be a lot more money put in the trust, and I felt that was to the benefit of my stockholders and I felt ultimately they would get out of that situation with a profit.

At the time of Mr. Groves' negotiations with Jeffrey Granger, Granger Trading Corporation had outstanding 16,294 shares of its capital stock.<sup>158</sup> Of these, 3,800 shares were held by members of the Granger family and employees of Sulzbacher, Granger and Company, members of the New York Stock Exchange.<sup>159</sup> The asset value of the Granger Trading Corporation stock was \$12.22 per share,<sup>160</sup> so that the total assets of the company aggregated \$199,112.68. Of prime importance, however, was the fact that these assets were all cash, except for \$15,000 in bonds.<sup>161</sup> The shares of Granger Trading Cor-

<sup>155</sup> Op. cit. supra, note 1, at 805-6 and Commission's Exhibit No. 33, and supplementary information supplied the Commission by The Equity Corporation. Yosemite's option to purchase up to 125,000 shares of Chain & General common stock from Groves had expired on February 1, 1932, but had been extended by Mr. Groves. (Op. cit. supra, note 1, at 793.) Similarly, Mr. Groves had been granted an extension on his repurchase obligation to Franklin Plan Corporation.

<sup>156</sup> Id., at 2254-5. Granger Trading Corporation had been organized as a management investment company on January 3, 1929, in Delaware under the sponsorship of the New York Stock Exchange firm of Sulzbacher, Granger and Company. (Id., at 2225-6.) From the outset and until control of the company was transferred to Yosemite Holding Corporation in 1932, the board of directors was composed exclusively of partners and employees of Sulzbacher, Granger and Company. (Id., at 2229.)

<sup>157</sup> Id., at 2263.

<sup>158</sup> Op. cit. supra, note 1, at 841.

<sup>159</sup> Id., at 2257-8, 2281.

<sup>160</sup> Id., at 2258.

<sup>161</sup> According to an audit of Granger Trading Corporation as of April 14, 1932, Granger Trading Corporation "had a net value of \$198,000, all in cash with the exception of \$15,000 worth of bonds". (Id., at 815, 2258 and Commission's Exhibit No. 108.)

poration had originally been sold at \$32.50 per share to the public, which included brokerage clients of Sulzbacher, Granger and Company.<sup>162</sup>

On April 21, 1932, Yosemite Holding Corporation purchased from David Granger, Jeffrey Granger, and their associates, their personal holdings of 3,800 shares of Granger Trading Corporation stock, at \$12.22 per share for a total of \$46,436.<sup>163</sup> On April 20, 1932, Yosemite Holding Corporation purchased from the treasury of Granger Trading Corporation 7,500 shares of that company's capital stock at its per share asset value of \$12.22, making a total of \$91,650.<sup>164</sup> The issuance of this stock increased the total amount of the stock outstanding to 23,794 shares and raised the company's assets to \$290,762.68.<sup>165</sup> These transactions gave Yosemite Holding Corporation 11,300 shares of Granger Trading Corporation stock, or approximately 47% of the total outstanding, sufficient to insure Yosemite Holding Corporation working control of that company.

Yosemite Holding Corporation, as has been shown, lacked the resources to finance the acquisition of Granger Trading Corporation. On March 24, 1932, it had exhausted its cash funds in purchasing 41,780 shares of Chain & General stock from Mr. Groves. Therefore, Yosemite Holding Corporation borrowed \$138,000 from its subsidiary, Chain & General Equities, Inc. in order to purchase the 11,300 shares of Granger Trading Corporation stock.<sup>166</sup>

The Granger family had in this manner permitted Wallace Groves to obtain at least working control of Granger Trading Corporation by selling to Yosemite Holding Corporation their personal holdings of Granger Trading Corporation stock, and arranging for the sale to Yosemite Holding Corporation of 7,500 shares of the Granger Trading Corporation's treasury stock.<sup>167</sup> This transfer of control was apparently motivated by the fact that the Granger interests received compensation from Yosemite Holding Corporation in addition to that received for their stock. Yosemite Holding Corporation paid Sulzbacher, Granger and Company \$19,500 for its management con-

<sup>162</sup> Op. cit. supra, note 1, at 2229, 2262.

<sup>163</sup> Id., at 2258.

<sup>164</sup> Id., at 2267.

<sup>165</sup> The implications of the issuance of the treasury stock to Yosemite are significant. As has been indicated, prior to the issuance of this stock, there were 16,294 shares of Granger Trading Corporation outstanding. Yosemite acquired 3,800 shares, or approximately 25% of the total, from the Granger group. The purchase of an additional 3,800 shares in the market or otherwise would have been necessary to give Yosemite Holding Corporation approximately 47% ownership, the percentage it actually acquired by purchase of the treasury shares. If these 3,800 shares had been purchased in the open market at their asset value, \$12.22 per share, the cost to Yosemite would have been approximately \$46,000, but the money would have been paid to individual stockholders and not to the Granger Trading Corporation. Yosemite, however, was purchasing control with a view to ultimate absorption of the assets of Granger Trading Corporation. It was important, therefore, from Mr. Groves' point of view that any sums paid for Granger Trading Corporation stock be paid to that corporation. The funds paid Granger Trading Corporation for its treasury stock became assets of that company and in one form or another would be returned to Yosemite upon absorption of the assets of Granger Trading Corporation. This absorption, in fact, took place as will be indicated hereafter. (See also Report of the Commission on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Pt. VII, p. 224.)

<sup>166</sup> Op. cit. supra, note 1, at 813-4, and Commission's Exhibit No. 108. Repayment was to be made within 40 days, i. e., by May 30, 1932, with 6% interest. (Ibid.)

<sup>167</sup> Op. cit. supra, note 1, at 2267, 2269.

tract with the investment company, a contract from which the sponsor had never made a profit. Jeffrey Granger testified with respect to this purchase as follows:<sup>168</sup>

Q. In addition to that purchase from you for cash for \$46,436, you received \$19,500 for the cancellation of your management contract; isn't that so?

A. That is right.

Q. Who paid that at that time?

A. Mr. Groves paid that.

Q. Mr. Groves paid it?

A. Yes.

Q. The fact of the matter was you testified today that the management contract had never given you a nickel throughout its entire period; isn't that so?

A. I don't think—well, I testified from the management contract itself we had not realized any profit.

Q. And here you were getting \$19,500 from Mr. Groves for cancellation of that agreement?

A. I don't think we cancelled the agreement. I think we sold it to him.

\* \* \* \* \*

Q. In any event, you got \$19,500 for the sale of your management contract?

A. That is right.

Moreover, Sulzbacher, Granger and Company received an additional \$6,000 for the cancellation of a lease between the firm and Granger Trading Corporation,<sup>169</sup> thus making a total consideration of \$71,936 received by the Granger interests, their associates, and Sulzbacher, Granger and Company.

On April 21, 1932, when Yosemite Holding Corporation acquired 47% of the voting power of Granger Trading Corporation, Yosemite Holding Corporation assumed direct control of the management of Granger Trading Corporation. Five of the six directors of Granger Trading Corporation resigned, only Jeffrey Granger retaining his directorship.<sup>170</sup> Wallace Groves and two of his associates, Ernest B. Warriner and William A. Brophy, filled three of the vacancies.<sup>171</sup> These men were at the same time directors of Yosemite Holding Corporation.<sup>172</sup> In addition, Jeffrey Granger and Myron Granger resigned as president and vice president of the company, and Messrs. Groves and Warriner, respectively, took their places.<sup>173</sup> Subsequently, during May, June, and July 1932, Yosemite Holding Corporation increased its holdings of Granger Trading Corporation stock to approximately 51% of the total outstanding.<sup>174</sup>

With voting and management control now assured, Mr. Groves was in a position to transfer the cash in the treasury of Granger Trading Corporation to Yosemite Holding Corporation. On May 2, 1932, two weeks later, a "Plan and Agreement of Reorganization" was entered into between Granger Trading Corporation and Yosemite

<sup>168</sup> Id., at 2259-61.

<sup>169</sup> Id., at 2261.

<sup>170</sup> Id., at 2265-6. Messrs. Unger, D. Granger, M. I. Granger, Umann and Lewyn resigned. (Derived from supplementary information supplied the Commission by The Equity Corporation.)

<sup>171</sup> Op. cit. supra, note 1, at 2265. The remaining vacancies were filled by Herbert C. Sargent and W. H. A. Austin. (Id., at 2265.)

<sup>172</sup> Derived from supplementary information supplied the Commission by The Equity Corporation.

<sup>173</sup> Op. cit. supra, note 1, at 2266, and supplementary information supplied the Commission by The Equity Corporation.

<sup>174</sup> Op. cit. supra, note 1, at 2270.

Holding Corporation.<sup>175</sup> By the terms of the "Plan," Granger Trading Corporation agreed to sell to Yosemite Holding Corporation all its assets, almost entirely in cash, then aggregating approximately \$290,000,<sup>176</sup> in return for 2,701¾ shares of the preferred stock and 10,807 shares of the common stock of Yosemite Holding Corporation. The "Plan," contemplating the subsequent dissolution of Granger Trading Corporation, provided that Yosemite Holding Corporation would waive its rights as a stockholder of Granger Trading Corporation, to the extent of 11,300 shares, to any distribution of Yosemite Holding Corporation stock by Granger Trading Corporation.<sup>177</sup>

The next day, May 3, 1932, the offer to purchase Granger Trading Corporation's assets was presented to its directors.<sup>178</sup> The board, dominated by Mr. Groves' nominees, accepted the offer and recommended that it be presented to the stockholders for acceptance.<sup>179</sup> Messrs. Groves and Warriner, two of the six directors of Granger Trading Corporation, were at the same time directors of Yosemite Holding Corporation.<sup>180</sup> At least two other directors of Yosemite Holding Corporation, Messrs. Sargent and Austin, were nominees of Mr. Groves. Thus, a majority of the new board of directors of Granger Trading Corporation were elected after Yosemite Holding Corporation had acquired almost a majority of Granger Trading Corporation's stock and, in fact, dominated the management at the time of the sale of Granger Trading Corporation's assets to Yosemite Holding Corporation.

Nor were the rights of the minority stockholders of Granger Trading Corporation adequately protected by the one remaining "independent" director, Jeffrey Granger. When Yosemite Holding Corporation's offer to purchase the assets of Granger Trading Corporation came before the directors of Granger Trading Corporation, Jeffrey Granger testified he did not approve the transaction:<sup>181</sup>

A. I was present at a meeting where that proposition was discussed.

Q. What did you say when that proposition was put up?

A. I said that I thought that it was a proposition that should be very seriously considered by the Board of Directors.

Q. Serious in what respect?

A. Serious as a step. Well, any sale of any assets of a corporation to another one is always a serious step.

\* \* \* \* \*

Q. Didn't you have any difficulty with that offer?

A. I had a great deal of difficulty with it.

Q. Did you ever approve it?

A. I never approved it.

Whatever Mr. Granger's reaction to this transaction may have been, however, he must have known that his objections would fall on the deaf ears of a board of directors that was dominated by Mr. Groves. Mr. Granger testified further:<sup>182</sup>

<sup>175</sup> Id., Commission's Exhibit No. 107.

<sup>176</sup> Id., at 2268, and Commission's Exhibit No. 108.

<sup>177</sup> Id., Commission's Exhibit No. 107.

<sup>178</sup> Id., at 2272.

<sup>179</sup> Id., at 2275.

<sup>180</sup> Derived from supplementary information supplied the Commission by The Equity Corporation.

<sup>181</sup> Op. cit. supra, note 1, at 2272-4.

<sup>182</sup> Id., at 2274-5.



Q. Did you think that because you didn't agree with it, you didn't approve it?

A. I didn't think that it was something that I could resolve myself. I felt that that was something for the controlling interests to determine. They were then responsible for the conduct of the corporation, and I felt that they were the ones really to pass upon the advisability of any such offer, but I did point out in the meeting that before this thing should be consummated, the directors should give it the closest attention, and to determine whether or not it was for the best interests of the stockholders.

Now, I was one out of six directors, and I presume that the Board of Directors did give it that thought and attention, and that they finally came to the conclusion that that was for the best interests of the stockholders.

\* \* \* \* \*

Q. Now, you knew that any speech that you were making at that meeting was being made to nominees of Mr. Groves, is not that so, and those were his people that he picked, isn't that so?

A. I knew that he picked that Board of Directors, but I didn't know that they would not exercise their best judgment in regard to what was best for the stockholders.

Although Mr. Granger "never approved" the sale of assets,<sup>183</sup> he did not vote against it.<sup>184</sup> He testified that he was not present at the meeting of the board of directors when action was taken upon the offer.<sup>185</sup> In fact, when proxies were solicited for approval of the sale of assets by stockholders,<sup>186</sup> Jeffrey Granger was one of the nominees in the proxy despite the fact that, as he testified, he had not approved the plan.

Although Mr. Granger testified that his name was used without his authority, and that he realized that the appearance of his name on the proxy might cause stockholders of Granger Trading Corporation to believe he approved the plan, he took no steps to remove this impression. Mr. Granger's testimony on this phase is as follows:<sup>187</sup>

Q. \* \* \* were you designated one of the proxies in the proxy that was sent out?

A. My name was on the proxy, but it was not done with my authorization.

Q. Did you object to it?

A. I certainly did. That was sent out without my consent and I certainly did object to it.

Q. On that score, did you write to the stockholders and say, "My name appears on this proxy, but it is not only without my consent, but against my wishes." Did you, Mr. Granger?

A. I considered that, but I didn't think it was advisable.

Q. And wasn't this the consequence, that a stockholder—

A. Because there were three or four other people there and, as a matter of fact, I didn't exercise any of those proxies. I didn't go to the meeting and I didn't exercise any of them.

Q. Isn't it a fact that a stockholder exercising that proxy, seeing your name there, would have the right to assume that you approved this transaction and the sale of all the assets of the trust in exchange for Yosemite Holding Company stock, and the truth is that you did not want your name there?

A. That is true.

\* \* \* \* \*

A. \* \* \* Anybody that asked me about it, I told them I neither approved nor disapproved of it. I gave them the facts.

After the board of Granger Trading Corporation had approved the offer of Yosemite Holding Corporation, only the consent of the stockholders of Granger Trading Corporation was needed to effect

<sup>183</sup> Id., at 2274.

<sup>184</sup> Ibid.

<sup>185</sup> Id., at 2272.

<sup>186</sup> Id., at 2284, 2290.

<sup>187</sup> Id., at 2290-2.



the sale of the assets of their company to Yosemite Holding Corporation. Under the laws of Delaware, which were applicable to the situation, a sale of assets could be consummated on the vote of a majority of the outstanding stock.<sup>188</sup> Since Yosemite Holding Corporation already held a majority of the outstanding voting power of Granger Trading Corporation, the public investors who held the minority block could not by their votes prevent the sale.

On May 25, 1932, a meeting of the stockholders of Granger Trading Corporation was called to vote on Yosemite Holding Corporation's offer.<sup>189</sup> Yosemite Holding Corporation, as majority stockholder of Granger Trading Corporation, voted to accept its own offer to acquire the cash assets of approximately \$290,000 of Granger Trading Corporation. Granger Trading Corporation was shortly thereafter dissolved.<sup>190</sup>

The Granger interests, after receiving the various payments mentioned above, either deliberately or unwittingly assisted Wallace Groves in acquiring, through Yosemite Holding Corporation, the cash of Granger Trading Corporation to enable him to meet his personal obligation of Franklin Plan Corporation.

As has been indicated, on April 20, 1932, Yosemite Holding Corporation purchased from Granger Trading Corporation, 7,500 shares of treasury stock for \$91,650. It might have been assumed that by this purchase additional funds were to be supplied to Granger Trading Corporation. However, two weeks later, on May 2, 1932, the plan of reorganization of Granger Trading Corporation, whereby Yosemite Holding Corporation was to obtain all the company's assets, consisting almost entirely of cash, was proposed and consummated shortly thereafter. By this device Wallace Groves, through Yosemite, not only received back the \$91,650 paid into the treasury of Granger, but also all the other cash assets of that organization.

<sup>188</sup> The appropriate provision of the laws of Delaware reads as follows (Delaware Revised Code (1935), Chapter 65, Section 65): "Every corporation organized under the provisions of this Chapter, may at any meeting of its Board of Directors, sell, lease, or exchange all of its property and assets, including its good will and its corporate franchises, upon such terms and conditions and for such consideration, which may be in whole or in part shares of stock in and/or other securities of, any other corporation or corporations, as its Board of Directors shall deem expedient and for the best interests of the corporation, when and as authorized by the affirmative vote of the holders of a majority of the stock issued and outstanding having voting power given at a stockholders' meeting duly called for that purpose, or when authorized by the written consent of the holders of a majority of the voting stock issued and outstanding, provided, however, that the Certificate of Incorporation may require the vote or written consent of the holders of a larger proportion of the stock issued and outstanding."

<sup>189</sup> Derived from supplementary information supplied the Commission by The Equity Corporation.

<sup>190</sup> *Ibid.* On July 25, 1932, two months after the sale of the assets of Granger Trading Corporation to Yosemite Holding Corporation, the directors of Granger Trading Corporation voted to dissolve the company and called a stockholders' meeting to approve the decision. The stockholders, at a meeting held August 29, 1932, with Yosemite Holding Corporation voting 53% of the required two-thirds of the outstanding voting stock, consented to the dissolution pursuant to Delaware Revised Code (1935), Chapter 65, Section 39. (*Ibid.*) Distribution of Granger Trading Corporation's assets was then made to stockholders of Granger Trading Corporation. Yosemite Holding Corporation participating only to the extent of its holdings in excess of 11,300 shares of Granger stock. The assets consisted of 2,701 $\frac{3}{4}$  shares of the preferred stock, 10,807 shares of the common stock of Yosemite Holding Corporation, and about \$2,300 in cash, representing a dividend on the Yosemite Holding Corporation preferred stock. (*Ibid.*, and *op cit. supra*, note 1, Commission's Exhibit No. 107.)

Manifestly, the purchase of the Granger Trading Corporation stock by Yosemite Holding Corporation was not for the purpose of strengthening the condition of Granger Trading Corporation but rather was a device to give Wallace Groves control of Granger Trading Corporation so that he could, through Yosemite Holding Corporation, obtain the cash of Granger Trading Corporation and use these funds in his own personal transactions.

Mr. Granger, when examined on his obligations to the other stockholders in Granger Trading Corporaion, testified:<sup>191</sup>

Q. The fact is you were the only ones out of that entire corporation, isn't that so, that sold your stock to Mr. Groves for cash?

A. You mean I, or the firm?

Q. You or the firm or your brothers or partners.

A. That is right.

Q. So that you got cash and the rest of the stockholders got Yosemite stock, isn't that so?

A. That was not part of my arrangement.

\* \* \* \* \*

Q. And it was at that time that you sold your stock for cash at \$12.22 per share, which was the liquidating value, and you got \$46,436, but the rest of the stockholders did not get cash, isn't that so?

A. They did not sell their stock. I was the only one sold my stock.

Q. You have testified before, Mr. Granger, that for a period prior to the time the Wallace Groves interest had taken control of the situation you were in this liquid position?

A. That is right.

Q. So, if you dissolved that corporation at that time every other stockholder would have gotten \$12.22 per share just the same as you?

A. That is true.

\* \* \* \* \*

Q. Did you get any other consideration at that time, either from Mr. Groves or from the Granger Trading Corporation?

A. Not that I know of.

Q. Didn't you get \$6,000 for the cancellation of a lease?

A. That is right.

Q. So that in addition to your getting cash of \$46,436 for your stock, you got \$19,500 for the sale of the management contract and \$6,000 for the cancellation of a lease?

A. That is right.

Q. And at that time had the corporation been dissolved every other one of the stockholders would have gotten \$12.22 also, isn't that so?

A. I don't know that the corporation could have been dissolved.

Q. It had cash, didn't it?

A. I know, but you have to get the consent of the stockholders, and I don't think they would have consented.

Q. The stockholders would not have consented?

A. I don't think so.

Q. Did you make an attempt to ask them if they wanted cash?

A. I canvassed a few, and I think most of them wanted to stay in the investment trust and recoup their losses. I think that is a natural thing for a man to do who has made an investment.

Q. Did you tell those people you wanted to turn over their cash to Mr. Wallace Groves to manage?

A. We didn't turn over the cash for them to manage. We sold our stock to Mr. Groves and our management contract.

Q. That is right. This stock of the Granger Trading Corporation had been sold to your clients, isn't that true?

A. That is true.

Q. Those people for whom you had acted as broker?

A. That is true.

<sup>191</sup> Op. cit. supra, note 1, at 2257-78.

Q. Those people whom you owed the highest fiduciary duty, not only as their advisers, but as the persons who had sold them the stock in the first instance, isn't that so?

A. That is right.

Q. You took the cash and they stayed in?

A. That is right.

\* \* \* \* \*

Q. Was there any attempt made to disclose it?

A. No, there was no attempt made to disclose it, and no attempt made to hide it. I think that it was a matter of public record, that that stock, that we had sold that stock to him, and that he bought 7,500 shares, and as a matter of fact, I think that the stockholders subsequently approved these various things by a more than 50 percent majority, and I was told that it was almost unanimous.

Q. Well, of course, don't you think that the stockholder may have relied a little bit on the fact that you were on the Board of Directors, and didn't object to it, and since you were the sponsors of the trust and had sold them the stock that you felt that it was a good idea?

A. I don't think so, because I think subsequent to my selling the stock, I think that Mr. Groves got out several letters to the stockholders, and I think that the stockholders felt, my impression of Mr. Groves was that he was properly a director of the corporation.

After repaying the \$138,000 which it had borrowed from Chain & General Equities, Inc.,<sup>192</sup> Yosemite Holding Corporation used some of the funds remaining out of the \$290,000 in cash received from the sale of its stock to Granger Trading Corporation<sup>193</sup> to finance Mr. Groves' personal obligation. On June 30, 1932, Yosemite Holding Corporation purchased from Mr. Groves 46,219 shares of Chain & General common stock at \$2.38 per share for a total of \$110,001.22.<sup>194</sup> This amount supplied Wallace Groves with the money to meet his commitment to Franklin Plan Corporation. Thus Mr. Groves, on the same day, bought the same number of shares from Franklin Plan Corporation at \$2.40 per share.<sup>195</sup> As a result of the purchase by Yosemite Holding Corporation from Mr. Groves of the Chain & General stock, Yosemite Holding Corporation obtained more than 50% of the voting power of Chain & General Equities, Inc.<sup>196</sup>

## N. Formation of The Equity Corporation

Wallace Groves, however, had not completely met his obligation to repurchase from Franklin Plan Corporation the 236,780 shares of Chain & General common stock which he had originally sold to that corporation. He had caused Yosemite Holding Corporation to purchase 89,749 shares.<sup>197</sup> He was still obligated to repurchase 147,031 shares at \$2.40 per share, or a total of \$352,874.40.<sup>198</sup> It will now be indicated how this obligation was ultimately liquidated.

<sup>192</sup> Id., at 831-2, and Commission's Exhibit No. 108.

<sup>193</sup> Id., Commission's Exhibit No. 107. Only about \$15,000 was represented by securities. (Ibid.)

<sup>194</sup> Op. cit. supra, note 1, Commission's Exhibit No. 33.

<sup>195</sup> Ibid. Mr. Groves took a loss of 2¢ per share, or a total of \$924.38. (Ibid.) Two weeks before, on June 15, 1932, Yosemite Holding Corporation had purchased from Franklin Plan Corporation, apparently directly, 1,750 shares of Chain & General common stock at \$2.38 per share for a total of \$4,165. (Ibid.)

<sup>196</sup> Op. cit. supra, note 108.

<sup>197</sup> Op. cit. supra, note 1, Commission's Exhibit No. 33.

<sup>198</sup> Id., at 307.

On December 7, 1932, Mr. Groves and Chase Donaldson with various of his associates<sup>199</sup> organized The Equity Corporation under the laws of Delaware as an investment company of the general management type.<sup>200</sup> Mr. Donaldson and his associates controlled Allied General Corporation, a company then engaged primarily in the distribution of securities.<sup>201</sup> Mr. Groves, himself, controlled Yosemite Holding Corporation through a personal holding company, Compania Montana,<sup>202</sup> a Panama corporation and, through Yosemite Holding Corporation, indirectly controlled Chain & General Equities, Inc., and Interstate Equities Corporation.<sup>203</sup>

On December 9, 1932, two days after the organization of The Equity Corporation, Mr. Groves and Mr. Donaldson and his associates turned into the new corporation their control holdings of Yosemite Holding Corporation and Allied General Corporation, respectively, in return for 1,650,000 shares of The Equity Corporation common stock. In addition, \$50,000 in cash was supplied The Equity Corporation in return for 50,000 shares of The Equity Corporation common stock. Out of the 1,700,000 shares thus issued, constituting all of The Equity Corporation's then outstanding stock, Mr. Groves received 1,150,000 shares for his control holdings of Yosemite Holding Corporation stock,<sup>204</sup> and Chase Donaldson and his associates received 500,000 shares for the Allied General Corporation holdings and 50,000 shares for the cash.

<sup>199</sup> These other associates were Herbert R. Anderson, W. F. Best, R. S. Elliot, Jr., Alfred M. Elsesser, Kenneth S. Gaston, and Eliot Sharp. (Public Examination, Allied General Corporation, at 5296 and Commission's Exhibits Nos. 495 and 496.)

<sup>200</sup> Op. cit. supra, note 1, Commission's Exhibit No. 831. From the outset it was the purpose of the sponsors of The Equity Corporation to cause the company not only to function as an investment medium, but also to engage in the acquisition of other investment companies and, following that, to simplify their corporate structures. (Derived from supplementary information supplied the Commission by The Equity Corporation.)

<sup>201</sup> Op. cit. supra, note 1, at 7830, 7848, 7852.

<sup>202</sup> By November 16, 1931, Mr. Groves had acquired 292,500 shares of Yosemite common for \$292,500. Commissions, fees, and other expenses increased the cost to \$363,356.29. On December 15, 1931, Mr. Groves sold these shares for \$150,000 to Wagegro Corporation, a Delaware corporation controlled by Mr. Groves. The sale, admittedly made to establish a loss for tax avoidance purposes, offset the net profit which Mr. Groves had realized on November 4, 1931, from the sale of 642,517 shares of the common stock of Interstate Equities Corporation to Chain & General Equities, Inc. Shortly thereafter, Wagegro Corporation sold the Yosemite common stock to Compania Montana, a Panama corporation, wholly owned by Mr. Groves. (Public Examination, Phoenix Securities Corporation, at 6036-40.)

Between November 16, 1931, and December 9, 1932, Mr. Groves or his affiliated companies purchased from Yosemite Holding Corporation and in the open market additional shares of the common stock of Yosemite Holding Corporation until their total holdings aggregated 327,532 shares, representing 50.1% of the voting power of the company. (Op. cit. supra, note 1, at 285, and Commission's Exhibits Nos. 185, 766 at 10, and 843; and derived from supplementary information material supplied the Commission by The Equity Corporation.)

<sup>203</sup> Op. cit. supra, note 1, at 7849.

<sup>204</sup> The Allied General Corporation stock had an asset value of about \$250,000. The Yosemite Holding Corporation stock had no asset value. Thus, on formation, The Equity Corporation's total assets, on the basis of liquidating value, were worth about \$300,000. Yosemite Holding Corporation, however, had voting control of Chain & General Equities, Inc. which in turn had voting control of Interstate Equities Corporation. The gross assets of these companies, together with the gross assets of Allied General Corporation, aggregating approximately \$6,500,000 at that time were thus brought under The Equity Corporation's control. (Id., at 7849-50, 11983-6, 11989-91, and Commission's Exhibits Nos. 766, 831, and 1173.)

### O. Sale of The Equity Corporation to David M. Milton

Within six months after the formation of The Equity Corporation, Mr. Groves sold his interest therein, consisting of 1,150,000 shares of the common stock, for \$1,050,000 to David M. Milton and Ellery C. Huntington, Jr., members of the New York law firm of Satterlee & Canfield.<sup>205</sup> Interstate Equities Corporation, as a result of collaboration between Messrs. Milton and Groves, ultimately put up the bulk of the cash needed by Mr. Milton to buy out Mr. Groves. The fact that Mr. Groves was indirectly in control of Interstate Equities Corporation<sup>206</sup> did not prevent him from participating in and profiting from the deal.

The mechanics and the details of this sale of the controlling block of The Equity Corporation stock are briefly outlined. On May 19, 1933, Messrs. Milton and Huntington caused Underwriters Equities, Inc., their controlled subsidiary, to sell 56,410 shares of American Colony Insurance Company stock and 41,601 shares of Colonial States Fire Insurance Company stock to Interstate Equities Corporation (an indirect subsidiary of The Equity Corporation) for \$894,812.90 in cash.<sup>207</sup> Underwriters Equities, Inc., then transferred \$705,010 of this cash to its controlled dummy corporation, Oceanic Insurance Company, Ltd., in return for all the capital stock of this company.<sup>208</sup>

On May 26, 1933, only one week later, Oceanic Insurance Company, Ltd., indirectly controlled by Messrs. Milton and Huntington through Underwriters Equities, Inc., bought outright from Compania Montana, the personal holding company controlled by Mr. Groves, 1,000,000 shares of The Equity Corporation common stock for \$900,000.<sup>209</sup> These funds consisted of the cash realized only the week before by Underwriters Equities, Inc., parent of the Oceanic Insurance Company, Ltd., by its sale of the insurance stocks to Interstate Equities Corporation. Thus, in effect, the funds of the indirect subsidiary (Interstate Equities Corporation) of The Equity Corporation were used by Mr. Milton to pay Mr. Groves for control of The Equity Corporation. Mr. Milton testified on this phase of the transaction as follows:<sup>210</sup>

Q. \* \* \* [the] situation was that on May [19] 1933, Underwriters Equities sells to Interstate Equities, at the time Wallace Groves [indirectly]

<sup>205</sup> Op. cit. supra, note 1, Commission's Exhibit No. 837. Mr. Huntington is still a partner of Satterlee & Canfield.

<sup>206</sup> It will be recalled that Wallace Groves, through his personal holding company, controlled The Equity Corporation which controlled Yosemite Holding Corporation. The latter in turn controlled Chain & General Equities, Inc., which in turn controlled Interstate Equities Corporation.

<sup>207</sup> Op. cit. supra, note 1, at 7917, and Commission's Exhibit No. 837.

<sup>208</sup> Id., Commission's Exhibit No. 837 and Securities Registration Statement for The Equity Corporation, Post Effective Amendment, filed with the Securities and Exchange Commission, July 17, 1937, Item 39.

<sup>209</sup> Op. cit. supra, note 1, Commission's Exhibits Nos. 718 and 837. Of the \$900,000, \$700,000 was paid in cash and \$200,000 in notes which were paid in November 1933. (Ibid.) The balance of Mr. Groves' Equity stock, 150,000 shares, was taken under option to be executed on or before June 1, 1934, by Oceanic Insurance Company, Ltd., at \$1 per share. (Id., Commission's Exhibit No. 718.) Oceanic Insurance Company, Ltd., exercised the option as to 75,000 shares in August 1934. The option on the other 75,000 shares was assigned to Chase Donaldson and exercised by him in May 1934. (Op. cit. supra, note 208.)

<sup>210</sup> Op. cit. supra, note 1, at 7905-6.

controls that company \* \* \* nine hundred thousand dollars worth of insurance stock, and one week later it takes [the] money it got [for] the insurance stock and buys a million dollars worth of stock of Equity Corporation from Mr. Wallace Groves? Isn't that so?

A. That is correct.

Q. \* \* \* The cash that was used by this interest to get control of The Equity Corporation was money that came from a subsidiary of The Equity Corporation? Isn't that so? \* \* \*

A. I think that is correct.

Mr. Milton further testified that one of the conditions of his purchase of The Equity Corporation stock from Mr. Groves was that Interstate Equities Corporation purchase the insurance stocks from the Milton interests. He claimed the reason for the purchase was that the insurance stocks were a "very valuable" investment over which the new management wished The Equity Corporation to secure control.<sup>211</sup> However, the transaction did supply Underwriters Equities, Inc., admittedly without cash and with no other assets except the insurance stocks,<sup>212</sup> with the funds necessary to enable Messrs. Milton and Huntington to purchase control of The Equity Corporation from Mr. Groves.

Mr. Milton denied, however, that at the time he sold the insurance stocks to Interstate Equities Corporation he had committed himself to Mr. Groves to use the proceeds of that sale to buy Mr. Groves' interest in The Equity Corporation. His testimony on that phase of the transaction follows:<sup>213</sup>

Q. You mean to say, Mr. Milton, that Wallace Groves was going to let Interstate buy a million dollars of that stock without having the commitment from you to buy a million dollars of Equity Corporation stock?

A. I had no commitment.

Q. Do you think he would have stood for one minute Interstate taking a million dollars of his money and putting it into these insurance companies, which were not insurance companies, because they reinsured that business, unless he was certain that when you got that million dollars you would turn it over to him?

A. He may have been certain, but he had no agreement with us.

Q. So that he knew when that stock was sold for a million dollars that he was going to get that million dollars?

A. He couldn't have known it; he may have surmised it—because it was not written and there was no such agreement.

Q. And didn't Mr. Wallace Groves say, "I will not let you sell a million dollars of this unless I have an assurance that you are going to take that million dollars and turn it over to me for the million \* \* \* [shares] in the Equity that I am going to give you?"

A. He did not say that.

Nevertheless, on May 19, 1933, the day on which Interstate Equities Corporation purchased the insurance stocks from Underwriters Equities, Inc., and a week before Mr. Groves actually transferred control to the Milton interests, Mr. Groves knew that Mr. Milton was "going to buy him out." This fact is made clear by the minutes of the meeting of directors of Interstate Equities Corporation, held on May 19, 1933, which state:<sup>214</sup>

In regard to the resignation of Mr. Groves, the Chairman stated that he had been advised that Mr. Groves expected to sell all or substantially all of his holdings in the common stock of The Equity Corporation to interests which controlled or were affiliated with the control of Underwriters Equities, Inc.

<sup>211</sup> Id., at 7906.

<sup>212</sup> Id., at 7917.

<sup>213</sup> Id., at 7915-6.

<sup>214</sup> Id., Commission's Exhibit No. 110

## P. Satisfaction of Wallace Groves' Obligation to Franklin Plan Corporation with Funds of United States Shares Corporation

As has been indicated, at the end of June 1932, Mr. Groves was still obligated to repurchase from Franklin Plan Corporation 147,031 shares of the common stock of Chain & General Equities, Inc., for a total of \$352,874.40.<sup>215</sup> In September 1933 Mr. Groves settled a threatened lawsuit of the preferred stockholders of Franklin Plan Corporation by agreeing to pay to Franklin Plan Corporation \$250,000 for the stock of Chain & General Equities, Inc.<sup>216</sup> Mr. Groves paid \$100,000 down and promised to pay the balance within two months after approval of the settlement by the creditors of Franklin Plan Corporation. However, Mr. Groves, after making a further payment of \$12,500 on April 24, 1934, defaulted, leaving a balance of \$137,500 still due.<sup>217</sup> Once more the burden of Mr. Groves' personal obligation was to be assumed by an investment company.

It has already been indicated that Mr. Groves had sold control of The Equity Corporation and its subsidiaries to Messrs. Milton and Huntington in May 1933. Less than a year later, on April 24, 1934, United States Shares Corporation (Maryland) and subsequently Group Assets, Inc., two companies closely affiliated with Messrs. Milton and Huntington,<sup>218</sup> assumed Mr. Groves' obligation to pay \$137,500 to the trustee in bankruptcy of Franklin Plan Corporation.<sup>219</sup> United States Shares Corporation (Maryland) agreed to pay the \$137,500 balance and interest by August 15, 1934, and to post with the trustee additional collateral consisting of 110,000 shares of The Equity Corporation common stock.<sup>220</sup> By July 1934 Franklin Plan Corporation received the balance on its settlement with Mr.

<sup>215</sup> *Id.*, at 307, and Commission's Exhibit No. 33.

<sup>216</sup> Before the stockholders' action was commenced, Franklin Plan Corporation went into bankruptcy and the trustee in bankruptcy pressed the claim. In his opinion the sale of the stock of Chain & General Equities, Inc., to Franklin Plan Corporation was a contributing cause of the bankruptcy of the latter company. (*Id.*, at 275, 276, 309-11, 313, 316, Commission's Exhibit No. 34, and derived from supplementary information supplied the Commission by The Equity Corporation.)

<sup>217</sup> *Op. cit. supra*, note 1, at 313. Apparently the default was dictated by Mr. Groves' unwillingness to pay rather than by his inability to do so. Between May and November 1933 Mr. Groves had received \$900,000 in cash as part payment on the sale of his Equity stock to the Milton interests. (See note 209 *supra*.)

<sup>218</sup> Mr. Milton was president and a director of United States Shares Corporation (Maryland) from about August 1932 to July 1933. The firm of Satterlee & Canfield, of which Messrs. Milton and Huntington were then partners, were attorneys for the company. Although, as of June 5, 1934, neither Mr. Milton nor Mr. Huntington owned any stock of United States Shares Corporation (Maryland), a majority of the board of directors were "friends or business acquaintances \* \* \* serving at the request of either David M. Milton or Ellery C. Huntington, Jr." (Post Effective Amendment, The Equity Corporation, Securities Registration Statement filed July 20, 1937, Prospectus, Rider 76 (a)). United States Shares Corporation (Maryland) in turn owned 44% of the stock of Group Assets, Inc. (*Op. cit. supra*, note 1, Commission's Exhibit No. 972.)

<sup>219</sup> *Op. cit. supra*, note 1, at 313-4, and Commission's Exhibit No. 972.

<sup>220</sup> *Id.*, Commission's Exhibit No. 972. Simultaneously, United States Shares Corporation (Maryland) assigned the obligations it had just assumed to Group Assets, Inc., 44% of the stock of which was owned by United Shares Corporation (Maryland). This was done because United States Shares Corporation (Maryland) did not have the 110,000 shares of Equity common stock required by the trustees as collateral. (*Ibid.*)



Groves from Group Assets, Inc., the controlled assignee of United States Shares Corporation (Maryland) and turned over the 147,031 shares of Chain & General common stock to Group Assets, Inc.<sup>221</sup>

## **Q. Effects of Wallace Groves' Activities on Controlled and Affiliated Companies**

### **1. FRANKLIN PLAN CORPORATION**

The experience of Franklin Plan Corporation while under the domination of Wallace Groves was disastrous. On October 5, 1931, Mr. Groves borrowed \$813,000 from the company in order to pay for the 542,517 shares of Interstate Equities Corporation stock which he had agreed to purchase from Bancamerica-Blair Corporation. This loan, although it was subsequently repaid, had drained the company's various loan offices of their liquid assets.

Subsequently, Mr. Groves made further use of Franklin Plan Corporation. On November 16, 1931, the company had purchased from Mr. Groves 236,780 shares of the common stock of Chain & General Equities, Inc., for \$568,272 with the understanding that Mr. Groves would repurchase the stock at cost to Franklin Plan Corporation within ninety days. This transaction, stated by the trustee in bankruptcy of Franklin Plan Corporation to have been a contributing factor to the company's bankruptcy, was not consummated until July 1934, two and one-half years later, when the repurchases were completed. The shares had been brought back for \$465,397.60, at a loss of \$102,874.40 to the stockholders of Franklin Plan Corporation.<sup>222</sup>

### **2. YOSEMITE HOLDING CORPORATION**

When Wallace Groves concluded negotiations for the acquisition of Yosemite Holding Corporation on October 7, 1931, the company had net assets of \$313,960 and possessed a portfolio of diversified securities having a market value of almost \$400,000, about 95% of the company's gross assets, \$425,736.29.<sup>223</sup> At the same time the outstanding preferred stock, entitled to \$51 per share on liquidation, was fully covered and the common stock had a net asset value of 17¢ per share.<sup>224</sup>

Yosemite Holding Corporation, in the process of acquiring stock of Chain & General Equities, Inc., liquidated the most substantial portion of its portfolio at a loss of \$187,612.49. Thus, at the end of 1931 Yosemite Holding Corporation's net assets with its holding in Chain & General Equities, Inc., taken at liquidating value, aggregated

<sup>221</sup> Op. cit. supra, note 1, at 314, and Commission's Exhibit No. 33. On July 10, 1934, Group Assets, Inc., turned in the 147,031 shares of Chain & General common stock to The Equity Corporation, controlled by Messrs. Milton and Huntington, for 147,031 shares of Equity common stock. (Derived from supplementary information supplied the Commission by The Equity Corporation.)

<sup>222</sup> Op. cit. supra, note 1, at 308, and Commission's Exhibit Nos. 33 and 972.

<sup>223</sup> Id., Commission's Exhibit No. 28.

<sup>224</sup> Id., Commission's Exhibits Nos. 28 and 185.



only \$52,907.38 and its diversified securities had an ascertainable market value of only \$3,990.<sup>225</sup>

By December 31, 1933, only a month before the dissolution of Yosemite Holding Corporation,<sup>226</sup> its net assets had decreased to only \$3,138.60, with its investment in Chain & General Equities, Inc. taken at liquidating value.<sup>227</sup> The company had no marketable securities in its portfolio and the asset value of its outstanding preferred stock, entitled on liquidation to \$51 per share, had shrunk to 43¢ per share.<sup>228</sup> Practically all of the company's assets, as a result of the repeated "unloadings" by Mr. Groves, had been invested in the common stock of Chain & General Equities, Inc. which, at the end of 1933, was carried on the books of Yosemite Holding Corporation at a cost of \$776,901.66.<sup>229</sup> Upon dissolution of Yosemite Holding Corporation, its holdings of the common stock of Chain & General Equities, Inc. were sold at public auction to its parent, The Equity Corporation, for \$215,000 for a loss of \$561,901.66.<sup>230</sup>

### 3. GRANGER TRADING CORPORATION

In April 1932, when Wallace Groves commenced negotiations for the acquisition of Granger Trading Corporation, the company had approximately \$290,000 of assets, almost all of which was in cash. The capital stock of Granger Trading Corporation had an asset value of \$12.22 per share. As has been indicated, shortly after Yosemite Holding Corporation acquired control of Granger Trading Corporation, Yosemite Holding Corporation purchased all the assets of Granger Trading Corporation in return for 2,701¾ shares of the preferred and 10,807 shares of the common stock of Yosemite Holding Corporation. Thus, Granger Trading Corporation under the domination of Mr. Groves surrendered its liquid assets in exchange for stock of Yosemite Holding Corporation, a company that no longer functioned as an investment company.

At the time of the dissolution of Granger Trading Corporation in August 1932, its assets consisted solely of the Yosemite preferred and common stock received at the time of the sale of its assets to Yosemite Holding Corporation and about \$2,300 in cash, representing a dividend on the Yosemite Holding Corporation preferred stock.<sup>231</sup> The minority stockholders of Granger Trading Corporation received, as their share of the assets of Granger Trading Corporation, a total of approximately \$2,100 in cash, 2,412 shares of Yosemite preferred stock, and 9,649 shares of Yosemite common stock, the two blocks of stock possessing an aggregate asset value of

<sup>225</sup> *Id.*, Commission's Exhibit No. 30, and see note 104, *supra*.

<sup>226</sup> Mr. Groves had disposed of control of Yosemite Holding Corporation to the Milton interests in May 1933, but there was no substantial change in the condition of the company between May and December 1933.

<sup>227</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. 843; and supplementary information supplied the Commission by The Equity Corporation.

<sup>228</sup> *Ibid.*

<sup>229</sup> Derived from supplementary information supplied the Commission by The Equity Corporation.

<sup>230</sup> *Op. cit. supra*, note 1, at 10742. For a discussion of the extent to which the auction price was controlled by The Equity Corporation see the Protective Committee Report, *op. cit. supra*, note 165, Part VII, Sec. IV, at 297-302.

<sup>231</sup> See note 190, *supra*.

\$5,547.60.<sup>232</sup> The minority stockholders of Granger Trading Corporation, holding 11,155 shares of the capital stock of Granger Trading Corporation, thus received assets worth approximately \$7,700, or about 69 cents per share held.<sup>233</sup> Since the stockholders of Granger Trading Corporation would have realized \$12.22 per share had the company been liquidated at the time Mr. Groves acquired control, they suffered a loss of about \$11.53 per share, as a direct result of acquisitions.

#### 4. CHAIN & GENERAL EQUITIES, INC.

A comparison of the financial condition of Chain & General Equities, Inc., at the time of acquisition by Mr. Groves with its condition at the date control of that company was transferred to the Milton interests in May 1933 indicates that the company did not prosper under Mr. Groves' management.

Diversification of assets almost completely disappeared. As of September 30, 1931, when Mr. Groves became associated with the company, it had net assets (at market or estimated fair value) of \$1,978,077.09, of which amount \$1,917,547.99, or 97%, was invested in diversified marketable securities.<sup>234</sup> At the end of June 1933, however, the net assets of Chain & General Equities, Inc., had decreased to \$1,272,942.20,<sup>235</sup> of which amount only \$511,858.13, or 40%, was invested in diversified marketable securities.<sup>236</sup> The bulk of the remaining assets of Chain & General Equities, Inc., was invested in the common and preferred stocks of Interstate Equities Corporation. This investment, which had cost Chain & General Equities, Inc., the sum of \$1,690,986.22, had an asset value of only \$494,827 at June 30, 1933.<sup>237</sup>

<sup>232</sup> Ibid. The asset value of the preferred stock, entitled on liquidation to \$51 per share, was estimated at approximately \$2.30 per share, valuing Yosemite Holding Corporation's general portfolio at market and its holdings of Chain & General common at net asset value; the Yosemite Holding Corporation common stock was without asset value. (Ibid. and op. cit. supra, note 1, Commission's Exhibit No. 843.)

On the basis of the market values of the Yosemite Holding Corporation stock, the Granger Stockholder fared little better. There was no market in the Yosemite preferred and the market prices of the common stock were as follows:

	High	Low
August 1932 -----	\$1	\$1½
September 1932 -----	1½	¾

(*Bank and Quotation Record*, September 9, 1932, p. 76, and October 7, 1932, p. 76.)

<sup>233</sup> Derived from supplementary information supplied the Commission by The Equity Corporation.

<sup>234</sup> Op. cit. supra, note 1, Commission's Exhibit No. 9.

<sup>235</sup> Op. cit. supra, note 1, Commission's Exhibit No. 235-L. In the valuation of total assets, investments in securities were taken at market or estimated fair value. The investment in the common and preferred stocks of Interstate Equities Corporation was taken at asset value, \$494,827. During the period from October 1, 1931, through June 30, 1933, there was returned to Chain & General Equities, Inc., preferred stockholders \$172,432.25 by the repurchase of 7,983 shares of Chain & General Equities, Inc., preferred stock, which had originally been issued for \$708,300. (Id., Commission's Exhibits Nos. 9, 19, 235-K, 235-L, and 843.)

<sup>236</sup> Op. cit. supra, note 1, Commission's Exhibit No. 235-L. In computing gross assets, \$1,286,786.40 of investments in securities were taken at market or estimated fair value, and the investment in the preferred and common stocks of Interstate Equities Corporation was taken at their asset values.

<sup>237</sup> Op. cit. supra, note 1, Commission's Exhibits Nos. 235-L and 843.

This shift in the investment policy of Chain & General Equities, Inc., was accompanied by a decline in the asset value of the outstanding preferred stock of the company. As of September 30, 1931, the preferred stock, with a par value of \$100 per share, had a net asset value of \$77.47 per share before the deduction of accrued and unpaid dividends of \$4.58 per share.<sup>238</sup> By June 30, 1933, the asset value of the preferred stock had shrunk to \$69 per share,<sup>239</sup> before the deduction of unpaid accrued dividends of \$13.87½ per share.

### R. Profits to Wallace Groves

It has been indicated that almost all of the companies which came under the control of Mr. Groves suffered severe losses. In the main, these losses were the result of transactions designed to aid Mr. Groves in the creation of a holding company system of investment companies under his control. Wallace Groves finally emerged as the dominant figure in Yosemite Holding Corporation and, through Yosemite Holding Corporation, in Chain & General Equities, Inc., and Interstate Equities Corporation. This controlling position in Yosemite Holding Corporation was represented by 327,532 shares of its common stock which, he testified, had cost him \$400,000.<sup>240</sup> However, at or prior to his purchase of Yosemite Holding Corporation stock, Mr. Groves had derived net profits of approximately \$450,000 from sales which he made of the common stock of Chain & General Equities, Inc., and Interstate Equities Corporation to companies under his control. Thus, in effect, the net cost to him of the acquisition of Yosemite Holding Corporation, carrying with it the control of Chain & General Equities, Inc., and Interstate Equities Corporation, was nominal.<sup>241</sup>

In December 1932, Mr. Groves had transferred to The Equity Corporation his holdings of Yosemite Holding Corporation stock in exchange for 1,150,000 shares of The Equity Corporation common stock. In May 1933, approximately one and a half years after he had acquired control of Yosemite Holding Corporation, Chain & General Equities, Inc., and Interstate Equities Corporation, Mr. Groves sold his holdings of The Equity Corporation stock to David Milton and his associates for \$1,050,000, the entire amount of which represented a profit to Mr. Groves.<sup>242</sup>

In accomplishing this result, interests of senior security holders and minority common-stock holders were either entirely disregarded or subordinated to the pecuniary interest of dominating personalities. Control of corporations was shunted back and forth between small financial cliques. The investing public, possessing the largest financial stake in these companies, was rarely consulted on fundamental questions involving transfer of control of their funds or changes in fundamental investment policies and activities of these companies.

<sup>238</sup> Id., Commission's Exhibit No. 9.

<sup>239</sup> Id., Commission's Exhibit No. 843 and 235-L. In making this computation, Chain & General Equities, Inc., holdings of the preferred and common stock of Interstate Equities Corporation were figured at liquidating value. (Ibid.)

<sup>240</sup> Op. cit. supra, note 1, at 253.

<sup>241</sup> See Appendix B, p. 781.

<sup>242</sup> The sale to the Milton interests was effected through foreign corporations so that Mr. Groves paid no federal income tax on this profit. (Public Examination, Phoenix Securities Corporation, at 6041.)

Nor were many of the individuals constituting the management concerned with their responsibilities to their stockholders. Passive subservience to Mr. Groves' wishes rather than observance of their obligations to stockholders characterized their actions. Mr. Groves was able to sell at substantial profits large blocks of securities to companies under his domination—in almost all cases without the objection of the management. Corporations under his control were persuaded to borrow large sums of money so that loans could be made to Mr. Groves to enable him to effectuate his program of acquisition and, compelled to liquidate their market portfolio securities, were then denuded of their cash to enable him to perform his personal obligations. Partial and misleading disclosures to stockholders apparently were effective in preventing corrective action on their part.

## VII. PETROLEUM CORPORATION OF AMERICA

### A. Summary

Petroleum Corporation of America was organized on January 16, 1929, by the investment banking house of Blair & Co., Inc. (later Bancamerica-Blair Corporation) which at that time was one of the bankers for Harry F. Sinclair, and Sinclair Consolidated Oil Corporation. Approximately seven weeks earlier, on November 26, 1928, a syndicate formed by Blair & Co., Inc., and Harry F. Sinclair, chairman of Sinclair Consolidated Oil Corporation's board of directors, had purchased from the Rockefeller interests 247,796 shares of stock of The Prairie Oil & Gas Company and 115,640 shares of stock of The Prairie Pipe Line Company for a total price of \$38,410,872. The syndicate paid \$13,410,872 in cash and borrowed the balance of \$25,000,000 from John D. Rockefeller, Jr., for a period of three months, pledging these blocks of Prairie stocks as collateral security. Associated with Blair & Co., Inc., and Mr. Sinclair in the syndicate were Arthur W. Cutten of Chicago, the Chase Securities Corporation (a security affiliate of Chase National Bank of New York) and Shermar Corporation (personal holding company of Albert H. Wiggin, president of Chase National Bank).

Immediately after its purchase of the Prairie stocks, in order to stimulate public interest and market activity in these stocks, the syndicate, with the consent of the Rockefeller interests, caused the shares of The Prairie Pipe Line Company to be split up four for one, and a 25% stock dividend declared. The shares of both The Prairie Pipe Line Company and The Prairie Oil & Gas Company were thereafter shifted from unlisted trading privileges on the New York Curb Exchange to official listing on the New York Stock Exchange. Four trading accounts were at once set up by the syndicate to operate, under the expert management of Arthur W. Cutten, in the stock of the two Prairie companies. During the month of December 1928 and the first three weeks of January 1929, these accounts traded heavily in both Prairie stocks, making total purchases aggregating \$12,576,143 and total sales aggregating \$11,998,682.

By January 21, 1929, The Prairie Oil & Gas Company stock, for which the Prairie Syndicate had seven weeks earlier paid \$57 per share, was selling on the market at \$65 per share, and The Prairie Pipe Line stock for which the syndicate had paid \$42 per share (calculated on the split-up basis of five shares for one) was selling at \$57 per share. On that date, January 21, 1929, the Prairie Syndicate sold to Petroleum Corporation of America, which Blair & Co., Inc. had organized largely for that purpose five days earlier, its entire holdings of both Prairie stocks. Petroleum Corporation paid the syndicate \$60 per share for the Prairie Oil & Gas stock and \$52 per share for the Prairie Pipe Line stock, thereby giving the syndicate a profit of about \$6,500,000.

Elisha Walker, president of Blair & Co., Inc., and a director of Sinclair Consolidated Oil Corporation, had been made chairman of the board of directors of Petroleum Corporation of America immediately upon its organization. Four other directors of Petroleum Corporation were associated with Blair & Co., Inc., and eight directors of Petroleum Corporation were, or thereafter became, directors of Sinclair Consolidated Oil Corporation.

In the circular offering Petroleum Corporation of America's stock for sale to the public it was announced that Petroleum Corporation of America was purchasing the Prairie stocks from a syndicate in which Blair & Co. was interested, at prices which were "below present market prices but in excess of cost to the syndicate." Not stated, however, were the means employed to establish or maintain "present market prices" nor the fact that the prices paid by the investment company was more than \$6,500,000 in excess of cost to the syndicate, representing a profit of approximately 49% on the syndicate's cash investment, realized in a period of seven weeks.

On January 22, 1929, Blair & Co., Inc., in association with a large number of other banking houses and security dealers sold to the public 3,250,000 shares of Petroleum Corporation's stock at \$34 per share, for a total of \$110,500,000. Of this sum \$100,750,000 was paid over to Petroleum Corporation and the balance of \$9,750,000 was retained by the underwriters and distributors. This spread, equal to approximately 10% of the proceeds to the corporation, was paid by Petroleum Corporation pursuant to the terms of an underwriting contract with Blair & Co., Inc., executed several days after the investment company's organization, at a time when it was still in the hands of "dummy" directors appointed by Blair & Co. Under this contract, Petroleum Corporation of America agreed to pay to Blair & Co., Inc., \$3 per share for all shares sold while Blair & Co., Inc., firmly committed itself only as to 20% of the total number of shares to be issued, and with respect to the balance agreed merely "to use its best efforts."

Moreover, although the stock was sold to the public on the basis of a \$20 down payment and the balance of \$14 payable on call any time after nine weeks, the sales commission to Blair & Co. was paid in full as soon as the initial \$20 payment was made by the purchaser.

In addition to the cash payment of \$9,750,000 to Blair & Co., Inc., and its associates, Petroleum Corporation issued to them, as further consideration for the distribution of its stock, 1,625,000 option warrants to purchase a like number of shares of Petroleum Corporation at any time within five years at the original public offering price of \$34 per share. These option warrants not only had a total market value in 1930 of about \$9,500,000, but the holders of the warrants could through their exercise at any time within five years, strengthen or reaffirm their control of the corporation and declared themselves one-third participants in any stockholders' equity in excess of \$34 per share.

In addition to the profits of more than \$6,500,000 realized on the sale of the Prairie stocks to Petroleum Corporation of America, the members of the Prairie syndicate received commissions of approximately \$1,900,000 as participants in the various groups formed by Blair & Co., Inc., to aid it in distributing the stock of Petroleum Corporation, plus 849,893 option warrants and \$321,742 additional in cash obtained from the sale of a portion of the option warrants.

Neither the public announcements relating to the formation of Petroleum Corporation of America, or any disclosed facts in connection with its organization and subsequent operations, gave indication to the public that the investment company was conceived and organized as an instrumentality to aid Sinclair and his banking associates of Blair & Co., Inc., to achieve a realignment of a section of the oil industry in which Sinclair was to be the focal point and dominant figure. Nevertheless, this purpose permeated the investment company's inception and colored its entire subsequent career.

The formation of Petroleum Corporation of America created, in effect, a hundred million dollar pool of the public's funds to be employed in furtherance of the plan to bring under the domination of the Sinclair interests a large section of the oil industry. Out of every dollar which the corporation possessed from its inception until 1938, approximately 88 cents were invested in, or committed to, ventures in which Sinclair and his bankers, Blair & Co., Inc. and Bancamerica-Blair Corporation, were directly and vitally interested.

Petroleum Corporation of America began its career with \$46,600,000, or approximately 46% of its total assets invested in the stocks of the two Prairie Companies. Despite an increasingly unfavorable outlook for these companies, the investment Company continued its purchases until its investment in the Prairie stocks totaled more than \$64,000,000. This heavy concentration of the investment company's funds in a single situation admittedly resulted from the insistent hope and desire of Petroleum Corporation's dominant influences for a consolidation of the Prairie companies with Sinclair Consolidated Oil Corporation.

Among its additional purchases of the Prairie stocks, a block of 150,000 shares of Prairie Oil & Gas stock was acquired by Petroleum Corporation directly from Sinclair Consolidated Oil Corporation for \$9,000,000, a price which was \$750,000

higher than the market value of the stock at the time. Simultaneously, Sinclair Consolidated Oil Corporation, apparently with the money received from Petroleum Corporation, purchased from Bancamerica-Blair Corporation 500,000 shares of Petroleum Corporation stock at a price substantially lower than the public offering price of the stock. Thereby Sinclair Consolidated Oil Corporation became Petroleum Corporation's largest stockholder and dominant influence and Bancamerica-Blair Corporation gained a profit of more than \$200,000. At the time these transactions were effected, Elisha Walker, chairman of Petroleum Corporation's Board of Directors, was also simultaneously president of Bancamerica-Blair Corporation and a director of Sinclair Consolidated Oil Corporation.

In another transaction which occurred shortly after its organization, Petroleum Corporation of America purchased 15,000 shares of Sinclair Consolidated Oil Corporation stock at peak prices aggregating \$600,000 from a syndicate operating a pool in that stock in which syndicate Blair & Co., Inc., and Harry F. Sinclair were participants. Three days after the sale of this block to Petroleum Corporation the syndicate closed operations and the market price of the Sinclair Consolidated stock thereupon began to sag. Petroleum Corporation, however, continued to add to its holdings of Sinclair Consolidated Oil stock until the end of 1931, when its investment totaled \$2,500,000 and showed a large book loss.

In March 1932, Sinclair Consolidated Oil Corporation, The Prairie Oil & Gas Company, and The Prairie Pipe Line Company were consolidated under the name of Consolidated Oil Corporation, and Petroleum Corporation of America exchanged its holdings in the three companies for Consolidated Oil stock. This stock, which had cost Petroleum Corporation of America approximately \$65,000,000, shortly after the exchange had a market value of approximately \$6,000,000. In connection with this consolidation, in favor of which Petroleum Corporation voted its large blocks of Prairie and Sinclair stock, Bancamerica-Blair Corporation received for "services" \$700,000, of which \$90,000 was ultimately paid over to Petroleum Corporation.

Following the consolidation of the Prairie and Sinclair companies, Petroleum Corporation of America continued to increase still further its holdings of stock in Consolidated Oil Corporation. In the meantime, Consolidated Oil Corporation, of which Harry Sinclair became chairman of the executive committee, increased its holdings of the stock of Petroleum Corporation. In this way there was established a system of circular ownership under which, at the end of 1935, Sinclair Consolidated Oil Corporation owned 39% of the stock of Petroleum Corporation, while Petroleum Corporation owned 11% of the stock of Consolidated Oil Corporation, and each corporation was the other's largest stockholder.

During the time that Petroleum Corporation of America was accumulating its large holdings of stock in the Prairie companies and in Sinclair Consolidated Oil Corporation, looking to a merger of these companies, the investment company was made a participant in two other ventures closely related to the Sinclair-Blair consolidation plans. One of these ventures, undertaken in January 1930, was designed to place the Sinclair interests in complete control of the Rio Grande Oil Company. In 1932 Consolidated Oil Corporation did succeed in acquiring all the assets and stock of the Rio Grande Oil Company by an exchange of stock. Petroleum Corporation, on the other hand, sustained a loss of approximately \$410,000 through its participation in the Rio Grande Oil Syndicate.

Shortly after it had made its commitment in the Rio Grande Oil Syndicate, Petroleum Corporation was also made a participant in a syndicate which undertook to furnish the money for the purchase by Mission Securities, Ltd., of 1,078,123 shares of Tidewater Associated Oil stock from Standard Oil Company of New Jersey at a price of \$23,147,300. This venture revolved about an attempt of the Sinclair interests to effectuate their consolidation plans by securing control of Tidewater Associated Oil Company. In this speculative undertaking Petroleum Corporation of America was caused to undertake a total commitment of over \$10,000,000, and it actually sustained a net loss of approximately \$2,000,000 without ever receiving a single share of Tidewater stock.

At the end of 1935 the total assets of Petroleum Corporation of America had shrunk from \$100,750,000 to \$34,413,892. After giving effect to repurchases of its own stock by the investment company and all dividends paid by it, the stockholders of Petroleum Corporation of America as of that date had sustained a loss, realized and unrealized, of \$54,058,000. An overwhelming portion of the total loss suffered by Petroleum Corporation and its stockholders was the direct consequence of ventures and investments undertaken by the Corporation evidently under the dictation of its dominant influences, Harry F. Sinclair and his banking associates of Blair & Co., Inc. and Bancamerica-Blair Corporation.



This dominant group, together with their associates and distributors, during the same period in which the general body of stockholders suffered losses of \$54,058,000, realized on their own behalf tangible cash benefits in excess of \$18,000,000. Moreover, at the end of 1935 the Sinclair interests, in part with the aid of Petroleum Corporation of America, had achieved control of a greatly expanded oil system, and they retained firm control of Petroleum Corporation as well.

## B. EVENTS PRECEDING FORMATION OF THE INVESTMENT COMPANY

Petroleum Corporation of America, for whose securities the public in January 1929 paid more than \$110,000,000,<sup>1</sup> was organized in connection with the efforts of Harry F. Sinclair, chairman of the board of directors of Sinclair Consolidated Oil Corporation<sup>2</sup> and his banking associates, Hunter S. Marston and Elisha Walker of Blair & Co., Inc.,<sup>3</sup> to consolidate a number of independent oil companies into one large system dominated by the Sinclair interests.

Two months before the formation of Petroleum Corporation, Blair & Co., Inc. and Harry F. Sinclair organized a syndicate which, on November 27, 1928, purchased from the Rockefeller interests substantial blocks of stock in The Prairie Oil & Gas Company<sup>4</sup> and The

<sup>1</sup> Public Examination, Petroleum Corporation of America, at 2843.

<sup>2</sup> Sinclair Consolidated Oil Corporation was incorporated in New York in 1919 as a holding company to take over the Sinclair Consolidated Oil Corporation (Delaware), Sinclair Oil & Refining Corporation, and the Sinclair Gulf Corporation. Through its operating subsidiaries it was engaged in the production, transportation, refining and distribution of petroleum and petroleum products (*Poor's Industrials*, 1932, p. 1888). The company was largely controlled by the Sinclair brothers, Harry F. and Earl W. Sinclair. Harry F. Sinclair was chairman of the board of directors of Sinclair Consolidated Oil Corporation and later chairman of the executive committee of Consolidated Oil Corporation. Earl W. Sinclair was president of Sinclair Consolidated from 1921 until 1932, at which time he became chairman of the finance committee of Consolidated Oil Corporation.

<sup>3</sup> Blair & Co., Inc., an investment banking company, was formed in 1920 by the merger of William Saloman and Company and Blair & Company, two investment banking houses. Blair & Co., Inc., handled the distribution of several of the Standard Oil issues (op. cit. supra, note 1, at 2841 and 2884) and also acted as banker for Sinclair Consolidated Oil Corporation. Elisha Walker was president and Hunter S. Marston was a director. In May 1929, shortly after the organization of Petroleum Corporation of America, Blair & Co., Inc., was merged with Bancamerica Corporation (investment affiliate of the Bank of America National Association) to form Bancamerica-Blair Corporation, of which Elisha Walker was chairman of the board, and Hunter S. Marston president. Bancamerica-Blair Corporation was thereafter an affiliate and subsidiary of Bank of America N. A. Elisha Walker became chairman of the executive committee of Bank of America N. A., of which A. P. Giannini was chairman of the board. Bank of America N. A. was controlled in turn by Transamerica Corporation, a financial holding company which controlled financial institutions with assets at that time aggregating 2½ billion dollars. (Among these institutions were Bank of Italy N. T. and S. A., Bank of America of California, Bankitaly Company of America.) At the end of 1929 A. P. Giannini became chairman of the advisory committee of Transamerica Corporation, and Elisha Walker was made chairman of the board of directors. (*Moody's Manual of Banks, etc.*, 1929, pp. 552-3 and 2518.)

<sup>4</sup> The Prairie Oil & Gas Company was incorporated in Kansas in December 1900, and until 1911 was operated as a subsidiary of Standard Oil Company of New Jersey. Following the decision in 1911 of the United States Supreme Court ordering the dissolution of the Standard Oil Trust as violative of the Sherman Anti-Trust Act, Standard Oil of New Jersey distributed among its stockholders all its holdings of The Prairie Oil & Gas Company stock. As of December 31, 1928, The Prairie Oil & Gas Company controlled oil and gas leaseholds on more than 1,000,000 acres in the leading producing sections of Kansas, Oklahoma, and Texas and produced more than 73,000 barrels of oil per day. Until 1915 The Prairie Oil & Gas Company owned and operated the Prairie Pipe Line system, but in January 1915, it formed The Prairie Pipe Line Company and distributed the capital stock ratably among its stockholders. As of December 31, 1928, The Prairie Oil & Gas Company had outstanding 2,426,181 shares of \$25 par common stock. (*Moody's Manual of Industrials*, 1929, p. 653.)

Prairie Pipe Line Company <sup>5</sup> for an aggregate price of approximately \$38,500,000.<sup>6</sup>

Negotiations had been in progress since 1927 between Sinclair and the officials of the two Prairie companies looking to a merger of the Prairie companies with the Sinclair Consolidated Oil Corporation. These negotiations were, according to Earl W. Sinclair,<sup>7</sup> carried on intermittently from 1927 until they were finally consummated in 1932.<sup>8</sup>

The Prairie companies were controlled by the Rockefeller family, their associates, and various Rockefeller charitable trusts.<sup>9</sup> Hunter S. Marston of Blair & Co., Inc. had been conferring since the early part of 1927 with the Rockefeller interests in an effort to acquire all the Prairie stock owned by three Rockefeller trusts.<sup>10</sup> These three trusts, the General Education Board, Laura Spellman Rockefeller Memorial, and Rockefeller Institute for Medical Research, together owned a total of 247,796 shares of The Prairie Oil & Gas Company and 115,650 shares of The Prairie Pipe Line Company.<sup>11</sup> The holdings of the three organizations constituted approximately 10% of the total outstanding stock of the oil company and 14% of the pipe line company.<sup>12</sup> Admittedly, these were effective blocks of stock for promoting a merger,<sup>13</sup> and by the same token these blocks in unfriendly hands might prove a formidable obstacle to a merger.<sup>14</sup>

Hunter Marston stated that he conducted negotiations for the purchase of the Prairie stocks with Bertram Cutler, the individual "who

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<sup>5</sup> The Prairie Pipe Line Company was incorporated in Kansas, January 1915 by The Prairie Oil & Gas Company, and its original capital was distributed to the stockholders of The Prairie Oil & Gas Company as a 150% stock dividend. The company functioned as a common carrier of crude oil in the state of Kansas, Oklahoma, Missouri, Iowa, Illinois, Indiana, and Texas. At the end of 1928 the company's oil transportation system was the largest in the industry. There were outstanding \$10,000 shares of \$100 par common stock (*Moody's Manual of Industrials*, 1929, p. 3000.)

<sup>6</sup> *Op. cit. supra*, note 1, at 2805-7 and Commission's Exhibit No. 317.

<sup>7</sup> *Id.*, at 3068.

<sup>8</sup> W. S. Fitzpatrick (president of The Prairie Oil & Gas Company in 1928 and 1929) testified (Hearings on Stock Exchange Practices, before the Committee on Banking and Currency, U. S. Senate, 73d Congress, pursuant to S. Res. 84 and S. Res. 56, Part 7, p. 3313) that prior to October 1928 negotiations between himself and Harry F. Sinclair had progressed to the point where a yardstick for measuring the respective properties of the two companies had been agreed on, and each company had sent representatives to study the books of the other. Earl W. Sinclair testified (*op. cit. supra*, note 1, at 3075) that toward the end of 1928 Sinclair Consolidated Oil Corporation commenced making purchases of the stock of The Prairie Oil & Gas Company.

<sup>9</sup> W. S. Fitzpatrick testified that "the stock represented by the Rockefellers, the trusts and people that had formerly been associated with the old gentleman in years gone by or their relatives [equaled] something like 40 or 42%." (Hearings on Stock Exchange Practices before the Committee on Banking and Currency, U. S. Senate, 73d Congress, Pursuant to S. Res. 84 and S. Res. 56, Part 7, p. 3307.)

<sup>10</sup> *Op. cit. supra*, note 1, at 2801. Hunter S. Marston was at the time one of the officers of Blair & Co. and subsequently became president of Bancamerica-Blair Corporation. He became a director of Petroleum Corporation at its inception, and later of The Prairie Oil & Gas Company and Consolidated Oil Corporation.

<sup>11</sup> *Id.*, Commission's Exhibit No. 317.

<sup>12</sup> It was testified at the public examinations before this Commission that the Rockefeller family itself owned a block of stock in the Prairie companies equal in size to that owned by the trusts and that the Rockefeller family continued to hold this block. (*Id.*, at 2837, 2905.)

<sup>13</sup> *Op. cit. supra*, note 1, at 2849 (testimony of Hunter S. Marston).

<sup>14</sup> *Id.*, at 3073 (testimony of Earl W. Sinclair).



represented them [the Rockefellers] in all their business dealings.”<sup>15</sup> These negotiations were carried on intensively over a period of some six months before the purchase agreement was entered into in November 1928.<sup>16</sup> The use which the prospective purchasers intended to make of the Prairie stocks after they acquired them was one of the questions carefully explored by Messrs. Marston and Cutler in their talks. Mr. Marston told Mr. Cutler that Blair & Co. had primarily in mind “the formation of a new oil unit.”<sup>17</sup> As Sinclair’s bankers, Blair & Co. had participated in the prior merger negotiations between Sinclair Consolidated Oil Corporation and the Prairie Companies.<sup>18</sup> By November 1928, however, the plans of the bankers and the Sinclair interests had become considerably more ambitious. Marston stated:<sup>19</sup>

A. \* \* \* We had, however, a more comprehensive idea in mind than that. We had studied the oil situation and we thought there was a very real opportunity to form another major company. We had in mind about four or five companies that fit into the picture that we felt would be a well-rounded unit. We had the Sinclair in mind, the Prairie Oil & Gas Company, the Prairie Pipe and Tidewater, and I believe two others.

Q. Barnsdall?

A. Barnsdall, and as I recall, Phillips.

Cutler, the Rockefeller representative, indicated to Mr. Marston that a merger between only the Prairie companies and Sinclair Consolidated Oil Corporation would not be viewed with favor at that time by the Rockefeller interests, but that they would not, however, object to the more comprehensive project of consolidating these companies with three or four others.<sup>20</sup> Hunter Marston testified:<sup>21</sup>

Q. In the course of the conversations with Mr. Cutler, did you discuss with him the purpose you had in mind for the acquisition of this block of Prairie Pipe and Prairie Oil & Gas Company Stock?

A. Yes, I did. I told him we had primarily in mind the formation of a new oil unit.

Q. Was there any discussion as to which companies were going to be merged in that unit?

A. Undoubtedly I told him what companies we had in mind, because my relations with him were such that I more or less disclosed anything I would have in mind.

Q. Was there any specific reference made to the Sinclair Consolidated Oil Company?

A. Yes, sir. I told him.

Q. What was said on that aspect?

A. I told him we had in mind the consolidation of three or four of the different companies, mentioning of course, the Consolidated, or the then Sinclair Company, as one of the major units. His mind ran to a larger plan that we had—at least, he liked the idea better of a consolidation of three or four of the other companies.

<sup>15</sup> Mr. Marston stated (id. at 2802): “He [Bertram Cutler] represented them in all their business dealings. Neither Mr. Rockefeller, Sr. or Jr. entered ever into any discussions with reference to the investments. Mr. Cutler is the agent or officer who handles that.”

<sup>16</sup> Mr. Marston stated (Id. at 2801) that the initial conversation had taken place some 18 months prior to November 1928. Serious negotiations commenced early in 1928.

<sup>17</sup> Id., at 2802.

<sup>18</sup> Id., at 2801.

<sup>19</sup> Ibid.

<sup>20</sup> Id., at 2803.

<sup>21</sup> Id., at 2802-4.

Q. Was anything specifically said with reference to a merger with Sinclair Consolidated Oil Company alone?

A. Yes; he said he would prefer to have the consolidation involve more than just two companies or three companies, Prairie Pipe, Prairie Oil and Gas and Sinclair.

Q. Was it merely a statement of preference, or did he say he wanted it?

A. Well, it was a statement which led me to say to him that we would not use our efforts to effect a consolidation between the Prairie Pipe and Sinclair companies at that time without his permission.

Q. That is, if the situation was [that] it was a question of merging the Prairie Pipe or Prairie Gas & Oil with Sinclair Consolidated only, \* \* \* the efforts of the bankers would not be used to effect that consolidation without a specific consent of the Rockefellers?

A. Exactly.

Q. But the broader picture could be accomplished, namely, the inclusion of the Tidewater, Barnsdall and Phillips, without your needing the consent of the Rockefeller interests?

A. That in a sense was the situation, although he naturally would have been acquainted with the purpose.

The formal agreement for the purchase of the Prairie stocks was consummated by an exchange of letters between Mr. Cutler and Blair & Co. on November 26 and 27, 1928. The three Rockefeller trusts sold to Blair & Co. their entire holdings, a total of 115,650 shares of The Prairie Pipe Line Company at \$210 per share and a total of 247,796 shares of The Prairie Oil & Gas Company at \$57 per share. The aggregate price for both blocks was \$38,410,872.<sup>22</sup> Simultaneously with the agreement of purchase, Mr. Cutler confirmed in writing to Blair & Co. that John D. Rockefeller, Jr., would personally lend to Blair & Co. the sum of \$25,000,000 for a period of three months at 6% interest, taking both blocks of Prairie stocks as collateral.<sup>23</sup> In consequence of this arrangement, Blair & Co. was required to pay down only \$13,410,872 of the purchase price and had a period of three months before the balance of \$25,000,000 was payable.

### C. Formation of Prairie Syndicate

The Cutler letters to Blair & Co. were written on November 26, 1928. The following day, November 27, Blair & Co. and Harry F. Sinclair together with three other parties entered into a syndicate agreement governing the Prairie purchase.<sup>24</sup> The additional contracting parties were the Chase Securities Corporation, Shermar Corporation, and Arthur W. Cutten. Arthur W. Cutten was described as "a Chicago businessman who was \* \* \* a member of the Wheat Exchange out there—a financier and Chicago capitalist."<sup>25</sup> The Chase Securities Corporation was the security affiliate of the Chase National Bank of New York, of which Albert H. Wiggin was president.<sup>26</sup> The Shermar Corporation was the personal family holding corporation of Wiggin.<sup>27</sup> The participation of each of the parties was 25%, except that Chase Securities Corporation received a  $\frac{2}{12}$  participation and Shermar Corporation a  $\frac{1}{12}$  participation, giving them a combined participation equal to that of the others.<sup>28</sup>

<sup>22</sup> Id., Commission's Exhibits Nos. 317, 318, 320, 321.

<sup>23</sup> Id., Commission's Exhibit No. 318.

<sup>24</sup> Id., Commission's Exhibit No. 319.

<sup>25</sup> Id., at 2812.

<sup>26</sup> Ibid.

<sup>27</sup> Ibid.

<sup>28</sup> Id., Commission's Exhibit No. 319.

The syndicate agreement in substance provided that the purchase of the Prairie stock by Blair & Co., although made in the name of Blair & Co., was for the account of all the parties to the agreement and that each of the parties agreed to participate in the purchase of the Prairie stocks in the proportions stated above. The agreement further provided that the parties would immediately form a syndicate or syndicates with Arthur Cutten as manager "to dispose of the Prairie Oil shares and of the Prairie Pipe shares in the market, or otherwise as the parties hereto shall determine." In addition to the formation of a syndicate, the parties agreed immediately to form trading accounts in the shares of common stock of both Prairie companies, such trading accounts to run for a period of six months, unless extended. It was also provided that the parties might grant subparticipations to such others as were agreed on, but "not to exceed in the aggregate 12% of the business."<sup>29</sup>

At the time of the formation of the Prairie syndicate the five parties who composed it were already joint venturers in another contemporaneous transaction of almost equal magnitude—the Sinclair Consolidated Oil Syndicate.<sup>30</sup> This syndicate, organized on October 24, 1928, had purchased from the Sinclair Consolidated Oil Corporation of which Harry F. Sinclair was president, 1,130,000 shares of the corporation's unissued stock at \$30 per share for a total of \$33,900,000. The purchase from the Sinclair Consolidated Oil Corporation was made in the name of Arthur W. Cutten, of Chicago, but was divided in the same manner as the Prairie syndicate: 25% each to Mr. Cutten, Mr. Sinclair, and Blair & Co.,  $\frac{2}{12}$  to Chase Securities Corporation and  $\frac{1}{12}$  to Shermar Corporation, the personal holding company of Mr. Wiggin.<sup>31</sup>

<sup>29</sup> *Ibid.* Subparticipations were later granted by the original participants to the following: The Famoth Corporation and the Traywin Corporation, both family corporations of E. R. Tinker, a director of Sinclair Consolidated Oil Corporation and the Chase National Bank, 1.75% each; the Haystone Securities Corporation, and the Haygart Corporation, affiliates of the banking house of Hayden, Stone & Co.  $\frac{1}{2}$  of 1% each; Equitable Trust Co. of New York (of which Charles Hayden of Hayden, Stone & Co. and Hunter S. Marston were directors, 2%; Continental National Corporation, security affiliate of the Continental National Bank of Chicago, 4%; Arthur Reynolds, then president of the Continental Bank of Chicago, 1%; L. W. Hill and C. O. Kálmán,  $\frac{1}{2}$  of 1%; Archie M. Andrews, 1%. By virtue of these subparticipations the participations of Blair & Co., Arthur W. Cutten and Harry F. Sinclair were reduced to 21.75% each, that of Chase Securities Corp. to 14.50%, and that of Shermar Corp. to 7.25%. (Op. cit. supra, note 1, at 2813-4; see Appendix D, *infra*, p. 785.)

<sup>30</sup> Op. cit. supra, note 1, at 2889-91. For a more detailed account of the Sinclair Consolidated Oil Syndicate, see Hearings on Stock Exchange Practices before the Committee on Banking and Currency, U. S. Senate, 73d Congress, Pursuant to S. Res. 84 and S. Res. 56, Parts 6 and 7.

<sup>31</sup> Hearings on Stock Exchange Practices before the Committee on Banking and Currency, United States Senate, 73d Congress, Pursuant to S. Res. 84 and S. Res. 56, Parts 6 and 7. It might be thought that the financial resources of individuals such as Mr. Sinclair and Mr. Cutten would be severely taxed in undertaking individual commitments of approximately nine and one-half million dollars each in the Prairie venture, following immediately after the Sinclair Oil Syndicate in which each had made a commitment of some eight and one-half million dollars, thus bringing the individual undertaking of Cutten, Sinclair and Blair & Co. in the two concurrent ventures to the sum of \$17,000,000 for each participant. However, in financial operations of this character, apparently, computations are made little in terms of ultimate commitments, but principally in terms of "spot cash" required and time allowed to pay the balance.

In the case of the Prairie stock purchase the participants were required to pay some thirteen million dollars down and had three months to pay the remaining twenty-five million dollars. In the case of the Sinclair purchase, however, the participants were not

The manager of the Sinclair Consolidated Syndicate was Arthur W. Cutten who operated from Chicago through the intermediary of his cousin Ruloff E. Cutten, a partner in the stock brokerage house of E. F. Hutton and Company. The Sinclair Syndicate officially wound up its activities in May 1929 with a net profit of \$12,420,492. Harry F. Sinclair received as his share of the profit \$2,664,340 and an almost identical amount was received by Arthur W. Cutten and Blair & Co., with the other participants being paid in proportion.<sup>32</sup>

The Sinclair Consolidated Oil Syndicate was admittedly planned and operated as a straight market distribution of the Sinclair Consolidated Oil Stock. Two syndicate trading accounts were operated by the syndicate during the period of distribution, the stock being disposed of or sold on balance to the public at prices which yielded a required to make any down payment at all. The contract between Mr. Cutten and the Sinclair Consolidated Oil Corporation provided that payment for the stock was to be made upon delivery of the stock and delivery was to take place at any time within one year, as demanded by Mr. Cutten, subject to the right of the corporation after thirty days from October 24, 1928, to require Mr. Cutten to take delivery of whole or part, on thirty days' written notice signed by the president or treasurer. Thus, under any circumstances, the syndicate had a minimum of sixty days from the date of purchase in which to make payment and as much longer time as the corporation was willing to allow it. Since Mr. Sinclair, the chairman of the board of the Corporation was a one-fourth participant, the syndicate could reasonably hope for indulgent treatment on the part of the corporation. In fact, not much time was required. The market operations of the syndicate, operating through two trading accounts, the original syndicate account and a second account called Sinclair Consolidated B Syndicate, were so successful that by the end of December 1928 the syndicate had taken delivery from the corporation of the entire number, 1,130,000 shares of stock, and had made full payment. The price of the stock had advanced to the point where the syndicate's brokers, E. F. Hutton & Company, were able to procure a substantial bank loan from the Chase National Bank (of which Mr. Wiggin was president) with which to effect payment. By virtue of this bank loan it appears that none of the Sinclair Consolidated Oil participants, except one, were ever required to put up any money of their own whatever during the entire operation. (Id., Part 6, pp. 3083-5 and 3345.)

<sup>32</sup> Hearings on Stock Exchange Practices before the Committee on Banking and Currency, United States Senate, 73d Congress, Pursuant to S. Res. 84 and S. Res. 56, Part 6, p. 3093, Committee Exhibit No. 114. The original members of the syndicate had granted a number of subparticipations. The list of participants as finally constituted and the percentages and profits received by each was as follows:

	<i>Share of profits</i>
Blair & Co.—22½%-----	\$2, 632, 962. 75
Chase Securities Corp.—15%-----	1, 755, 308. 75
Shermar Corporation (Albert H. Wiggin)—7½%-----	877, 654. 25
The Cutten Co., Ltd. (Arthur W. Cutten)—22½%-----	2, 632, 962. 75
H. F. Sinclair—22½%-----	2, 632, 962. 75
Continental National Corporation (Chicago)—4%-----	468, 082. 27
Arthur Reynolds—1%-----	117, 020. 57
Archie M. Andrews—1%-----	117, 020. 57
The Famoth Corporation—1¾%-----	204, 785. 99
The Traywin Corporation—1¾%-----	204, 785. 99
L. W. Hill and C. O. Kalman—½ of 1%-----	58, 510. 29

Cutten Co., Ltd., granted subparticipations to Lawrence Fisher and George Breen, and upon the termination of the syndicate they received the following share of profits based upon these subparticipations:

Lawrence Fisher-----	\$585, 102. 83
George Breen-----	292, 551. 41

The total net profit of the principal syndicate account was \$12,002,109.41 out of which William S. Fitzpatrick, president of The Prairie Oil & Gas Company was paid 2½%, a total of \$300,052.73, and the remaining \$11,702,056 was divided in the amounts above set forth. (For the details of the payment to W. S. Fitzpatrick see *infra*, pp. 264-6.)

In addition to the profits listed above, the second trading account, Sinclair Syndicate B Account, consisting of some of the original syndicate members and a number of new participants, divided profits totaling \$418,383.54, of which Arthur W. Cutten received \$37,654; Blair & Co., Inc., \$41,838; and Harry F. Sinclair, \$31,379. (Ibid., Committee Exhibit No. 115.)

substantial profit to the participants. Elisha Walker, of Blair & Co., contended at the public examination before the Commission that this oblique method of distribution of the Sinclair stock was almost the only way by which the Sinclair Consolidated Oil Corporation could raise the large sum of money it required, because the corporation's background was inadequate from an investment point of view and presumably could not support a public offering. Mr. Walker testified:<sup>33</sup>

Q. Now, about this time, Mr. Walker, Blair and Company, of course, was interested in the Sinclair Consolidated Oil trading account? Wasn't that so?

A. Which?

Q. Do you remember there was a syndicate formed to purchase 1,130,000 shares of Sinclair Consolidated Oil Company, in which Blair and Company, Shermar, Chase Securities——

A. And Cutten?

Q. Cutten.

A. Yes.

Q. Practically the same participants in the Sinclair trading account as there were in this?

A. Yes.

\* \* \* \* \*

Q. There was a public distribution of that stock through the medium of trading accounts on the Exchange?

A. Yes.

Q. And that one (Sinclair Consolidated Oil Corporation distribution) commenced about the same time as this (Prairie Oil and Prairie Pipe). They had disposed of every single share they had bought from Sinclair Consolidated and, as you recall, they made a profit of \$13,000,000, isn't that so?

A. I don't remember whether it was \$12,000,000 or \$13,000,000. I remember it was a very large amount.

Q. Yes. Then, as you recall that transaction, didn't you use precisely the same technique as was intended to be used in the case of Prairie Pipe and the Prairie Oil, namely, you purchased the block of stock from the Sinclair Consolidated Oil Company and immediately two trading accounts were commenced at E. F. Hutton and Company, run by Ruloff Cutten?

A. Yes.

Q. And through the instrumentality of trading on the Exchange and selling on balance, you finally disposed of the entire block at a profit? Isn't that so?

A. Yes.

Q. Now, there was no public distribution in that case by making an advertised offering to the public?

A. No.

Q. There you used the medium of trading accounts on the Exchange to effect distribution of the stock? Isn't that so?

A. Yes, but Consolidated Oil stock, Sinclair Consolidated Oil stock, was a very different proposition, marketwise, than any of the Standard Oil subsidiaries. I mean, you must draw a real difference there, that Standard Oil subsidiaries were considered investment stocks, and certainly both Prairie Oil and Gas and Prairie Pipe Line were in that category, and bankers wouldn't hesitate to make an issue of that stock, whereas at the time Sinclair Consolidated had not the background of it that the Standard Oil subsidiaries had.

<sup>33</sup> Op. cit. supra, note 1, at 2889-91.

I mean, it was a comparatively new institution which had been growing and fighting its way, and it was about the only means, about the only means, that the capital could have been raised for the Sinclair Consolidated at that time.

The Prairie stocks, however, unlike the Sinclair Consolidated Oil stocks were, as Mr. Walker testified,<sup>34</sup> considered "investment stocks," of a character akin to those of the Standard Oil Companies, and these stocks were susceptible of distribution through the usual method of a public offering, if the purchasing syndicate desired to employ that means. Elisha Walker testified that a public offering was in fact one of the possibilities considered by the Prairie syndicate.<sup>35</sup> A public offering, however, would have entailed breaking up both these substantial blocks of Prairie Pipe Line and Prairie Oil & Gas stocks and disposing of the stocks to the public in small lots. Similarly, a public distribution of the stock by market operation, such as was being effected in Sinclair Consolidated Oil stock, would also have required dispersion of the stock. Sinclair and his bankers, Blair & Co., were able to devise a plan whereby both blocks of Prairie stocks could be sold to yield the syndicate a substantial profit, without relinquishing control of these shares, which would undoubtedly prove of great assistance in effecting the merger of the Prairie companies with the Sinclair Company. Elisha Walker testified that the substance of such a plan was a "general thought in the back of one's head":<sup>36</sup>

Q. \* \* \* At the time they purchased it [the Prairie stocks] what was the intention of the group, was it to effect a distribution, or was it to organize an investment trust? What was in the minds of the individuals who made a substantial commitment at that time?

A. That it would do one of two or three things; it would either make a distribution by a public offering, as distinguished from a market operation \* \* \* or that we would hold the block of stock for a while in the hope that some consolidation might be worked out or still further in the back of their heads, but not, I would say, as a real immediate thought, but just a general thought in the back of one's head that maybe it would be advisable to form a corporation to handle it. I think the corporation idea was the third thought, rather than the first thought.

Whatever difference of opinion might have been entertained by the various members of the Prairie syndicate as to the best plan for the ultimate disposition of these blocks of stocks, two points were elementary. First, regardless of which plan of distribution or disposal was employed, the purchasing syndicate to make a profit had to sell the stock at a price higher than the syndicate had paid for it. In consequence, it was fundamental that the market price of the Prairie stocks had to reach a price higher than the purchase price. Second, the distribution of the stock had to be effected within a period of three months from November 26, 1928, if the proceeds of the sale of these blocks of stock were to be used to repay the \$25,000,000 loan due on that date, which was made by John D. Rockefeller, Jr., to the syndicate at the time of the syndicate's purchase of the Prairie stocks. In addition, this three-month disposal period had to be shortened, if the interest liability on the loan accruing at the rate of \$125,000 each month was to be curtailed.

<sup>34</sup> See *supra*, p. 236.

<sup>35</sup> *Id.*, at 3050.

<sup>36</sup> *Id.*, at 3048.

## D. Market Operations in the Prairie Stocks

At the time of the purchase by the Blair-Sinclair Syndicate of the shares of The Prairie Oil & Gas Company and The Prairie Pipe Line Company neither of these stocks was listed on the New York Stock Exchange. Both Prairie stocks were admitted to unlisted trading privileges on the New York Curb Exchange, but they were not active stocks.<sup>37</sup>

Table 1 indicates the range of prices and the volume of trading in each of these stocks from January 1928 until December 1928, at which

TABLE 1.—*Price quotations at intervals of approximately 2 weeks and monthly volume of sales of The Prairie Oil & Gas Company and The Prairie Pipe Line Company common stocks from Jan. 1, 1928, to Dec. 1, 1928*

Week ending—	The Prairie Oil & Gas Company			The Prairie Pipe Line Company		
	High	Low	Monthly volume	High	Low	Monthly volume
1928						
Jan. 14	50 $\frac{1}{4}$	48 $\frac{3}{4}$		187	184	
Jan. 28	49 $\frac{3}{4}$	48 $\frac{7}{8}$	33, 100	186 $\frac{1}{2}$	185	4, 560
Feb. 11	49 $\frac{1}{2}$	48 $\frac{1}{8}$		187 $\frac{3}{4}$	186 $\frac{1}{2}$	
Feb. 25	49 $\frac{7}{8}$	48	32, 700	214	206 $\frac{3}{4}$	20, 800
Mar. 17	49 $\frac{1}{4}$	48 $\frac{1}{2}$		223	202	
Mar. 31	49 $\frac{3}{8}$	48 $\frac{1}{4}$	30, 400	220 $\frac{1}{2}$	215	13, 870
Apr. 14	50 $\frac{1}{2}$	49 $\frac{5}{8}$		218 $\frac{1}{2}$	215 $\frac{1}{4}$	
Apr. 28	54 $\frac{7}{8}$	51 $\frac{3}{4}$	46, 600	217	214	4, 200
May 12	53 $\frac{3}{4}$	52 $\frac{1}{2}$		215	213	
May 26	52 $\frac{1}{2}$	51 $\frac{5}{8}$	88, 400	214	213	6, 350
June 16	51	48		215 $\frac{1}{4}$	211 $\frac{3}{4}$	
June 30	49 $\frac{3}{8}$	48 $\frac{1}{2}$	17, 600	212	205 $\frac{1}{2}$	20, 850
July 14	48 $\frac{3}{4}$	47 $\frac{1}{2}$		210	207 $\frac{3}{4}$	
July 28	48 $\frac{3}{4}$	47 $\frac{5}{8}$	23, 000	207 $\frac{3}{4}$	200	3, 550
Aug. 11	49	47 $\frac{1}{4}$		194 $\frac{3}{4}$	188	
Aug. 25	47 $\frac{1}{4}$	46 $\frac{1}{4}$	25, 300	188	183 $\frac{3}{4}$	22, 050
Sept. 15	47 $\frac{1}{2}$	46		190	182 $\frac{1}{2}$	
Sept. 29	49 $\frac{1}{4}$	47 $\frac{1}{4}$	48, 400	191	186 $\frac{1}{2}$	6, 900
Oct. 13	47 $\frac{1}{2}$	46 $\frac{3}{8}$		186	184	
Oct. 27	55 $\frac{3}{4}$	47	126, 500	215 $\frac{1}{2}$	191	23, 650
Nov. 10	56 $\frac{3}{4}$	54		225	215	
Nov. 24	61	54 $\frac{1}{4}$	370, 700	247	218	75, 350
Dec. 1	68	62 $\frac{1}{2}$		278	250	

time the purchase of the Prairie stocks was made.<sup>38</sup> The price of The Prairie Pipe Line Company stock was \$184 to \$187 per share at the beginning of that year; rose to a high of \$223 in March (about the time that intensive negotiations commenced between Blair & Co. and Bertram Cutler for the purchase of the stock); eased off to a low of \$172 in August;<sup>39</sup> and remained continuously below \$200 during the months of August, September, and most of October. Toward the end of Octo-

<sup>37</sup> Hunter Marston stated (op. cit. supra, note 1, at 2824): "You have to take this into consideration. These two stocks, particularly the Prairie Pipe Line Company's had been rather inactive stocks. There was practically no trading in them except from time to time."

<sup>38</sup> The table shows the range of prices on a biweekly basis. Some of the highs and lows quoted in the text, above, are not shown in the table because they occurred on dates intermediate to those used in the table.

<sup>39</sup> August 4, 1928.



ber, as negotiations between Mr. Marston and Mr. Cutler approached a successful conclusion the Prairie Pipe stock rose to \$215½ per share on increased volume,<sup>40</sup> and from that point pushed to a high of \$247 per share on the 23rd of November. It was on November 26th that the sale from the Rockefeller interests to Blair & Co. was actually effected at \$210 per share.

The Prairie Oil & Gas Company stock at the beginning of 1928 was about \$49 per share; rose to a high of \$52¾ in June;<sup>41</sup> eased off to a low of \$46 in August; fluctuated narrowly between \$46 and \$49 during August, September, and October; rose to \$55¾ at the end of October; and pushed to a new high of \$65¼ on the 23rd of November. The Blair & Co. purchase from the Rockefeller interests on November 26, 1928, was made at \$57 per share.

During the six months period, therefore, in which it was testified negotiations were in progress between Blair & Co. and the Rockefellers, the market price of the Pipe Line stock frequently was below \$200 per share, and that of the Prairie Oil & Gas stock below \$50 per share, while the syndicate paid \$210 per share of Prairie Pipe stock and \$57 per share of Prairie Oil & Gas stock. Clearly, if Blair & Co. were to make a quick profit on the basis of the prices they had paid, the market in these stocks required not only support but stimulation through increased market interest and activity.<sup>42</sup>

On November 26, 1928, the day on which the purchase of the stocks by the syndicate was consummated, Blair & Co. commenced to purchase blocks of both Prairie stocks. On November 26th, Blair & Co. purchased from Banks & Company 650 shares of Prairie Pipe at \$230, and 200 shares at \$225, and on November 27, 350 shares at \$250, these purchases totaling \$283,421.<sup>43</sup> At the same time the bankers purchased blocks of The Prairie Oil & Gas Company stock aggregating 28,000 shares at prices ranging from \$62 to \$65⅛ at a total

<sup>40</sup> October 27, 1928.

<sup>41</sup> June 2, 1928.

<sup>42</sup> Although during the weeks immediately preceding the date on which the purchase was made, the stocks pushed through on heavy volume to the prices paid by the syndicate, and even higher, this advance merely anticipated the important market news which was about to be made public, and it was to be expected that, in normal fashion, once the news was out the stock would settle back. The reported prices and volume of the Prairie stocks during the week prior to the purchase is shown in the following table:

Date	The Prairie Oil & Gas Company			The Prairie Pipe Line Company		
	High	Low	Volume	High	Low	Volume
1928						
Nov. 17.....	54¾	54½	500	218¾	218¾	100
Nov. 19.....	54¾	54½	5,000	220	219	1,000
Nov. 20.....	57¼	54¼	12,000	220½	219¼	1,500
Nov. 21.....	61	58	56,000	221	218	1,500
Nov. 22.....	61	59	22,000	219	218	750
Nov. 23.....	65¼	61	60,000	247	218	5,000
Nov. 24 <sup>a</sup> .....						
Nov. 25 <sup>b</sup> .....						
Nov. 26.....	67½	65¾	40,000	259	250	4,500

<sup>a</sup> Exchange closed.

<sup>b</sup> Sunday

<sup>43</sup> Op. cit. supra, note 1, at 2830 and derived from supplementary information supplied the Commission for Petroleum Corporation of America.

cost of \$1,815,337.<sup>44</sup> With respect to the effect of these concentrated purchases in the two relatively inactive Prairie stocks Hunter S. Marston of Blair & Co. testified:<sup>45</sup>

Q. Blair & Co. on November 26, 1928, purchased from W. S. Banks & Company 650 shares at 230, and on the same day they purchased from Banks & Company 200 at 225, and the following day, November 27, 1928, they purchased 350 shares at 250.

So that the very purchases Blair & Co. were making in the open market on the date they made this agreement with the Rockefeller interests increased the price of that stock from 225 to 250. Those very purchases moved that stock up 25 points, isn't that so? There was a difference of 25 points in those purchases?

A. Well, the stock went up 25 points.

Q. And the stock went up with the purchases made at prices ranging from 225 to 230 to 250 by Blair & Company?

A. Blair & Company apparently made those purchases according to your record, but I don't know what other purchases were made.

Q. Not only did it make those purchases in Prairie Pipe Line on that date, but on that very day it signed that agreement it purchased the 28,000 shares of Prairie Oil and Gas at prices ranging from 62 to 64.25 [sic; 65½], for a total of \$1,815,000. So that, Mr. Marston, the fact that the market was what it was at that time is no criterion, because there was Blair & Company, on the very day they had signed the agreement with the Rockefeller interests, purchasing the Prairie Pipe stock at prices ranging from 25 to 250 and at prices ranging from 62 to 64.25 [sic; 65½], for the Prairie Oil & Gas Company stock?

A. We thought the inherent value, naturally, of those stocks was cheap at that price.

Q. Well, that is so, is it not, every time people run a trading account or a pool account? The justification every time is that the pool participants feel that the stock is not selling at the price it is worth and they are just going to stimulate a little interest to call the public's attention to the fact that it is a cheap stock. And then when the stocks reach the price that they think it is worth they sell the stock and step out? Isn't that the justification in every pool—"the stock is not selling for what it is worth, and we are going to put it up to what it is worth, and sell it to the public"?

A. I imagine there have been many instances of that.

<sup>44</sup> These purchases were all made in a single day, November 26, 1928, as follows (derived from supplementary information supplied the Commission for Petroleum Corporation of America):

11/26/28----	300 shares—Carpenter-Cutter Co., @ 64.25-----	19,327.50
11/26/28----	700 shares—Carpenter-Cutter Co., @ 64.00-----	45,273.50
11/26/28----	2,000 shares—Carpenter-Cutter Co., @ 64-----	128,350.
11/26/28----	1,000 shares—W. S. Banks, @ 63¾-----	64,000.
11/26/28----	2,000 shares—W. S. Banks, @ 64-----	128,250.
11/26/28----	800 shares—W. S. Banks, @ 64¾-----	52,000.
11/26/28----	900 shares-----	57,307.50
11/26/28----	100 shares-----	6,353.
11/26/28----	1,300 shares-----	83,127.50
11/26/28----	600 shares-----	37,850.
11/26/28----	700 shares-----	44,017.50
11/26/28----	1,200 shares-----	75,210.
11/26/28----	200 shares-----	12,325.
11/26/28----	16,200 shares-----	1,055,835.
28,000		
Interest-----		6,799.58
Total-----		1,815,337.08

<sup>45</sup> Id., at 2830-1.

The Syndicate had made careful preparations to furnish other unfailing market stimuli. Increased trading had barely commenced when the news was released that the Prairie Pipe stock was to be split four for one and a 25% stock dividend was to be declared.<sup>46</sup> In addition, both the Prairie Oil and Prairie Pipe stocks were to be moved from unlisted trading on the Curb to listing on the New York Stock Exchange, the "Big Board." That these moves had been discussed with the Rockefellers and had formed part of the understanding on which the purchases had been made is attested by a letter addressed to Bertram Cutler on November 27, 1928, by Elisha Walker of Blair & Co., Inc.:<sup>47</sup>

Referring to our letter to you dated November 27, 1928 (confirming purchase of the Prairie stocks), we understand that it is agreeable to Mr. John D. Rockefeller, Jr., and other interests owning shares of common stock of the Prairie Pipe Line Company represented by you, that the Prairie Pipe Line Company shall change the par value of its common stock from \$100 per share to \$25 per share, increase the number of shares of such common stock and issue, upon such recapitalization and in part as a stock dividend, 5 shares of the par value of \$25 each in exchange for each share of such common stock now outstanding. You will give or cause to be given proxies in respect of all shares of common stock of the Prairie Pipe Line Company standing in the name of nominees of interests represented by you on the record date fixed for the purpose of determining the names of stockholders entitled to vote at the meeting called for the purpose of approving such change and increase.

We understand that you have no objection to an application on the part of the Prairie Oil and Gas Company and/or the Prairie Pipe Line Company to list its or their capital stocks upon the New York Stock Exchange.

The Prairie Oil & Gas stock was officially listed on the New York Stock Exchange on December 19, 1928; the Pipe Line stock on January 9, 1929. The split-up of the Pipe Line stock was not actually effected until January 4, 1929, but trading in the new stock (\$25 par) commenced on a "when issued" basis on December 4, 1928.

Hunter S. Marston, discussing the reasons for the Prairie Pipe split-up, stated:<sup>48</sup>

A. \* \* \* I believe that [the stock split-up] had been contemplated before we bought the stock, and, furthermore, it gave us an instrumentality from the standpoint of distribution which was important, in that it was much more easy if you would want to sell it in the market, because the stocks selling around \$250 a share do not have a particular appeal as far as investors are concerned, and it is a cumbersome quotation to handle \* \* \*.

Q. That is, you can hope to get a wider distribution if the stock is selling at \$50 a share than if it is selling at \$210 a share?

A. That is correct.

Q. That is obvious?

A. Yes.

\* \* \* \* \*

Q. Now, if I may discuss a little with you the aspect of the public distribution. The fact that the stock was split up was, you say, a safeguard in case public

<sup>46</sup> Id., at 2815.

<sup>47</sup> Id., Commission's Exhibit No. 320.

<sup>48</sup> Id., at 2815 and 2821.

distribution had to be effected the stock would be in such form the public would take it up?

A. It is in a more marketable form. A security that is selling at \$50 a share is something the people prefer to buy rather than at \$210 a share.

Ruloff Cutten, who was at that time the manager on the floor of the New York Stock Exchange of the successful Sinclair Consolidated Oil account, and who was, at least nominally, in charge of the Prairie operation, testified as follows concerning the effect on the market of these concerted moves:<sup>49</sup>

Q. Well, you notice prior to November 23, 1928, in both Prairie Oil and Gas, and Prairie Pipe Line, there was comparatively negligible volume. Isn't that so?

A. That is right.

Q. And on November 26, we find a certain marked spurt in activity?

A. That is right.

Q. Now, it was on November 26 that Blair and Company started buying those Prairie Pipe Line (shares), which were turned over to E. F. Hutton in each one of those accounts?

A. Yes.

Q. Now, with a little news that there was going to be a split-up of the Prairie Pipe Line stock, and the stock dividend, and with some purchasing by Blair and Company, that would certainly have an effect on the volume, and the price, isn't that so?

A. Decidedly so.

\* \* \* \* \*

Q. And all you need with the news of the split-up and the stock dividend, is the initial trading to give the impetus to the stock, and to get the volume going?

A. I should not think that they would need any with that news, a 5 for 1.

Q. It always looks a little better when it starts to come out on the tape, doesn't it?

A. Yes.

Q. And people don't really become conscious of the fact how good everybody believes the news is, until they see somebody buying the stuff?

A. That is right.

Q. So that on November 26, we find Blair and Company starting to buy both Prairie Pipe, and Prairie Oil and Gas, and that certainly didn't depress the price of the stock, did it?

A. No; it would not.

Q. And in your expert opinion it would have a slight tendency to start the price up, wouldn't it?

A. It would.

While the news of the Prairie Pipe five for one split and the impending shift of both stocks to the "Big Board" was being disseminated, the Prairie Syndicate, under the expert management of Arthur W. Cutten,<sup>50</sup> commenced operations. Four trading accounts were immediately set up with the brokerage house of E. F. Hutton & Company, the firm out of which the Sinclair Consolidated Syndicate accounts were being run. The Prairie market operation was modeled after the Sinclair Consolidated operation: two accounts were operated in

<sup>49</sup> Id., at 3114-5.

<sup>50</sup> Mr. Cutten was at that time managing the extensive operations of the Sinclair Consolidated syndicate, for which purpose he had been especially sought out by Harry F. Sinclair. (Op. cit. supra, note 31, Part 6.)

Prairie Oil & Gas stock and two accounts in Prairie Pipe stock,<sup>51</sup> Questioned as to the similarity between the two operations, Elisha Walker testified: <sup>52</sup>

Q. I am just trying to see whether at least the same mechanics were not set up?

A. Yes; the same mechanics were set up.

Q. The fact of the matter is that immediately upon the purchase of this \$38,000,000 worth of stock from the Rockefeller interests, two trading accounts were set up, in the Prairie Pipe Line Company's stock at E. F. Hutton, and in the Prairie Oil and Gas Company stock?

A. Yes.

Q. And immediately trading was done in those four accounts? Isn't that so?

A. Well, I can't answer that. I don't doubt it is correct, but I can't answer it. I haven't the figures.

The trading accounts in both Prairie stocks started on November 30, 1928, several days after the purchase of the stock by the Syndicate. The Prairie Pipe trading accounts took over at the outset the 1,200 shares [old] of Prairie Pipe stock which Blair & Co. had accumulated prior to the establishment of the trading accounts, and in addition immediately acquired other substantial blocks. On December 4, 1928, the accounts commenced trading in the new Prairie Pipe \$25 par stock on a "when issued" basis. By the time the Prairie Pipe accounts ceased operations on January 28, 1929, they had bought a total of 59,900 shares of Prairie Pipe stock for \$3,314,693 and sold 88,150 shares for \$4,860,478.<sup>53</sup> During this period there was traded on the Exchange a total of 208,100 shares of Prairie Pipe stock. The purchases of the

<sup>51</sup> The original syndicate agreement dated November 27, 1928, between Blair & Co., Inc., Chase Securities Corporation, Shermar Corporation, Arthur W. Cutten, and Harry F. Sinclair provided (1) "that the parties \* \* \* agree immediately to form a syndicate or syndicates with Arthur Cutten as manager thereof, with customary powers, to dispose of Prairie Oil shares and of the Prairie Pipe shares, in the market, or otherwise as the parties shall determine," and (2) "the parties hereto hereby agree immediately to form a trading account in the shares of common stock of Prairie Oil, the aggregate commitment for such account not to exceed 150,000 shares of such stock, and a trading account in the shares of common stock of Prairie Pipe, the aggregate commitment for such latter account not to exceed 50,000 shares of such stock as at present constituted, and such trading accounts to run for a period of 6 months from the date hereof with such extension or extensions of such period as the parties hereto shall determine. After making allotments to others in each such trading account as the parties hereto shall determine, the parties hereto shall participate in the balance of each such trading account in the respective proportions in which they participate in the original purchase and sale of the Prairie Oil Shares and of the Prairie Pipe Shares as herein set forth. Arthur W. Cutten shall be manager of such trading accounts with customary powers."

The provision for the trading accounts was later (December 3, 1928) implemented by two formal contracts between Arthur Cutten and all the participants and subparticipants, called Prairie Oil and Gas Syndicate Agreement "B" and Prairie Pipe Line Syndicate Agreement "B." The parties to these contracts were virtually the same as to the original syndicate purchase contract of November 27, with the inclusion of the various subparticipants listed supra (see note 29). The first account in each stock was known as "the syndicate account" and the second account (the syndicate "B" account) was known as "the trading account." Pressed to explain the reason for the establishment of two accounts in each stock, Ruloff Cutten stated that the purpose was to provide added purchasing power for the initial accounts in both stocks. He testified (*Id.*, at 3116): "Because the original group to have purchasing power over the number of shares, fortunately it started off by selling stock, but we didn't know whether they would continue to do so, so we had to have some buying power."

<sup>52</sup> *Op. cit. supra*, note 1, at 2892.

<sup>53</sup> *Id.*, Commission's Exhibit No. 350.

Syndicate equaled 26% of the total trading volume on the Exchange during the entire period and its sales equaled 38% of the total trading volume. The account ended up with its sales exceeding its purchases by 28,210 shares of the new stock, which "short" position was subsequently covered from the block of 578,250 shares of new Prairie Pipe stock (or 115,650 shares of the old Prairie Pipe stock) purchased by the Syndicate from the Rockefellers, thereby reducing that block to 550,000 shares of the new stock.<sup>54</sup>

The general course of the market prices of the Prairie Pipe stock during the period from November 3, 1928, to March 2, 1929, is shown in Table 2, which may be compared with Table 1 (*supra*) showing market prices from January 14, 1928.<sup>55</sup> The Prairie Pipe stock rose

TABLE 2.—Price quotations at intervals of approximately 2 weeks and monthly volume of sales of The Prairie Oil & Gas Company and The Prairie Pipe Line Company common stocks from Nov. 3, 1928, to Mar. 2, 1929

Week ending—	The Prairie Oil & Gas Company			The Prairie Pipe Line Company				
	High	Low	Monthly volume	High		Low		Monthly volume
				Old	New	Old	New	
1928								
Nov. 10.....	56 $\frac{3}{4}$	54		225	45	215	43	
Nov. 24.....	61	54 $\frac{1}{4}$	370,700	217	49 $\frac{3}{8}$	218	43 $\frac{5}{8}$	* 75,350
Dec. 1.....	68	62 $\frac{1}{2}$		278	55 $\frac{5}{8}$	250	50	
Dec. 15.....	59 $\frac{3}{4}$	56 $\frac{1}{2}$			51 $\frac{3}{4}$		49 $\frac{3}{4}$	
Dec. 29.....	52 $\frac{1}{4}$	50 $\frac{1}{2}$	144,000		52		51 $\frac{3}{8}$	76,801
1929								
Jan. 12.....	62	59 $\frac{1}{4}$			55 $\frac{1}{8}$		53 $\frac{1}{2}$	
Jan. 26.....	65	59	371,900		57		55	103,400
Feb. 16.....	60	58 $\frac{1}{8}$	130,100		57 $\frac{7}{8}$		56 $\frac{1}{8}$	117,700
Mar. 2.....	62 $\frac{1}{2}$	59			58 $\frac{7}{8}$		58	

\* Old.

from a low of \$208 at the beginning of November 1928 to \$250—\$278 at the beginning of December 1928, or in terms of the new \$25 par stock, from \$41 $\frac{5}{8}$  to \$50—\$55 $\frac{5}{8}$ , as compared with the cost of Prairie Pipe to the Syndicate of \$42 per share, new stock. During December 1928 the market price of the stock fluctuated between \$48 and \$55, and during January 1929 between \$56 $\frac{1}{2}$  and \$53 $\frac{1}{8}$ , reaching a new high of \$57 on the significant dates, January 21 and January 22.

The Prairie Oil & Gas trading accounts were evidently a more difficult operation than the Prairie Pipe accounts, and were less successful. The first Prairie Oil & Gas account was terminated January 14, 1929, with total purchases of 24,200 shares for the sum of \$1,490,273 and total sales of 35,500 shares, for the sum of \$2,258,525.<sup>56</sup> That account ended up "short" 11,300 shares, but the price of the

<sup>54</sup> Ibid.

<sup>55</sup> As in the case of Table 1, p. 238, *supra*, the dates used are biweekly, and consequently do not show highs and lows on intervening dates.

<sup>56</sup> Op. cit. *supra*, note 1, Commission's Exhibit No. 348.

stock advanced scarcely above \$60 per share. Since the Syndicate had paid \$57 per share for this stock, the spread between cost and market was not impressive.

The second account in The Prairie Oil & Gas Company stock started purchasing heavily on January 14, at prices ranging upwards from \$60 and by the important date of January 21, the price of Prairie Oil & Gas had reached \$65 per share. However, the account on that date had accumulated an excess of 53,300 shares of Prairie Oil & Gas stock,<sup>57</sup> and in addition the stock began to back away from the \$65 price, so that purchases had to be further increased. By January 28 the account was "long" 89,300 shares. On February 5, 1929, the account disposed of 52,204 shares in a manner which will be discussed hereafter. As of that date, the two Prairie Oil accounts had purchased 157,400 shares of Prairie Oil & Gas stock for \$9,261,400 (of which 118,000 shares were purchased on the Exchange) and sold 114,700 shares for \$7,126,343 (of which 51,196 shares were sold on the Exchange).<sup>58</sup> During the same period, the total volume of Prairie Oil & Gas stock traded on the Exchange was 480,100 shares. Without including its extensive transactions off the Exchange, purchases of the Syndicate equaled 25% of total exchange trading during the entire period and its sales equaled 11% of total exchange trading.

After February 5, 1929, the activity of the Prairie Oil & Gas trading account decreased, but sporadic purchases of Prairie Oil & Gas stock were made from time to time during the following twelve months. On February 28, 1930, when the Prairie Oil & Gas trading account was finally closed, it was still "long" 39,400 shares, which were distributed to the Syndicate participants at \$69.50 per share. The market price of the stock at the time was approximately \$47.50 per share. Thus, this account showed a substantial operating loss, while the other accounts resulted in an aggregate operating profit of \$96,280.<sup>59</sup>

Both Hunter Marston and Elisha Walker, in discussing the establishment and operation of the trading accounts, contended in effect that the objective of the Syndicate was merely to "police" the market in these stocks, and thereby protect itself in its purchase.<sup>60</sup> Hunter Marston testified:<sup>61</sup>

Q. You say there was a nominal market in the stock at the time the purchase group acquired it?

A. Yes.

Q. Then the effect of these trading accounts was to stimulate activity in that stock. Isn't that so?

A. That is one of the purposes, I assume.

\* \* \* \* \*

<sup>57</sup> That is to say, the account was "long" 53,300 shares. Since the objective of the account was not to accumulate stock, but only to raise the market price in order to inflate the ostensible value of the syndicate's holdings, this "long" position was a disadvantage and indicated that the account managers were having difficulty in stimulating enough market demand to enable the syndicate to dispose of its purchases without depressing the market price and thereby wiping out any enhancement which had been gained by means of these purchases.

<sup>58</sup> Op. cit. supra, note 1, Commission's Exhibit No. 348.

<sup>59</sup> Ibid.

<sup>60</sup> Op. cit. supra, note 1, at 2827 (testimony of Hunter S. Marston), and id., at 2895 (testimony of Elisha Walker).

<sup>61</sup> Id., at 2826.



Q. So there were four accounts opened in those two stocks, and isn't that indicative that the public distribution of that stock was contemplated at that time?

A. It is hard to remember now just what was in mind. As I told you, the original idea in the purchase of these shares was for an oil consolidation. While you are holding a large block of stock you naturally have got to protect in a sense your market, and I assume that is why those trading accounts were formed. We had such a large block of those stocks that naturally in those days they made the market for different securities.

Q. And they needed four accounts to do that, just to police the issue?

A. I don't know about that.<sup>62</sup>

From the records of the trading accounts it is apparent that the Syndicate was not, as was contended, attempting merely to ensure an orderly market for the stocks—a "policing" operation—but was instead actively striving to push the stocks to new high levels and to maintain them there.<sup>63</sup> The first objective, the inflation of the market prices, was substantially accomplished, as Ruloff Cutten conceded,<sup>64</sup> by the stock splitting device and the news of the listing on the New York Stock Exchange, abetted by the initial trading on the part of Blair & Co., Inc. The four trading accounts apparently had for their function to hold the prices at their highs and to advance them a little further, if possible. To accomplish this end, these four accounts in a period of two months made purchases of the two Prairie stocks aggregating \$12,576,143 and made sales aggregating \$11,986,821.<sup>65</sup> These accounts did a substantial volume of total exchange trading in both stocks over the entire period.<sup>66</sup> On certain days their transactions constituted the great bulk of all trading.<sup>67</sup> Of special significance is the fact that these accounts traded on the highs repeatedly. With respect to the Prairie Pipe Line account, Ruloff Cutten testified:<sup>68</sup>

Q. Do you have, commencing with December 3, 1928, do you have the prices, either on the 4th or the 5th, the highest price which you paid for the stock on that day?

A. On the 4th. Is that which you are referring to?

Q. Give it to us for the 4th.

A. 55½ high, and 54½ low.

<sup>62</sup> Elisha Walker stated (id., at 2895) " \* \* \* the main effort was to stabilize the market and hold your investment as a good investment rather than let some sharpshooter come and sell your stock down, and you had to have a syndicate to protect yourself in that respect."

<sup>63</sup> See the testimony of Ruloff Cutten, quoted *infra*, in which Mr. Cutten admitted that the records of the account show that the syndicate manager was attempting to "maintain" the market in The Prairie Oil & Gas Company at about 60, the price at which the syndicate had determined to sell to Petroleum Corporation of America.

<sup>64</sup> Testimony quoted, *supra*, p. 242.

<sup>65</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. 350.

<sup>66</sup> See percentages, *supra*, p. 245.

<sup>67</sup> Mr. Cutten testified (*op. cit. supra*, note 1, at 3119 and 3122):

Q. Now, you notice on December 5, 1928, the volume of transactions by the trading account in Prairie Pipe Line Company almost equaled the total volume on the N. Y. Stock Exchange \* \* \* you say that that amount of trading was necessary to police the stock on that day?

A. No; it wouldn't appear that by looking at it.

Q. \* \* \* Now, you notice that although the volume decreased, they still did a substantial portion of the trading in the Prairie Line Company, all of the way down.

A. Yes.

<sup>68</sup> *Op. cit. supra*, note 1, at 3124-5.

Q. Do you know what the high on that day was?

A. No, I don't know.

Q. The high on that date was 55½. What is the highest price that you paid?

A. 55½.

Q. For the next day?

A. December 5th—55¾.

Q. Do you know what the high was for that day?

A. 55¾.

Q. Do you know what December 6th high was?

A. 55½.

Q. Do you know what was the high which you traded that day?

A. 55½.

\* \* \* \* \*

Q. You were selling [buying] pretty frequently at the high, isn't that so?

A. Yes.

\* \* \* \* \*

Q. The record indicates that you traded at the high on the 17th, on the 18th, on the 19th, the high on the 21st, the high on the 24th, \* \* \* the high on the 27th, the high on the 31st, and the high on January 2d, and the high on January 8th, and the high on January 9th, and the high on January 14th, and the high on January 15th, and the high on January 16th, and the high on January 19th, and that was getting pretty close to the time when they were going to make an announcement that they were going to sell Petroleum Corporation, the Prairie Pipe and Oil stock, isn't that so?

A. I don't recall that date.

Q. January 21st, January 22d, and then on the 23d, and then you stopped trading, according to our records, on the 25th. But on the 22d, you made a new high of 57 and on the 23d at 57. Now you won't deny, Mr. Cutten, that the market price at least at that period was being made by the trading account, will you?

A. Naturally, it had something to do with it, if I actually bought the stock at the high. Of course that would be right.<sup>69</sup>

<sup>69</sup> With respect to the significance of trading on the highs, Mr. Cutten testified (id., at 3106):

Q. Now, the manner of handling a trading account depends on the purpose you hope to accomplish?

A. That is true.

Q. If you are just policing an issue, then the technique is entirely different than if you are trying to dispose of a block?

A. That is right.

Q. It is different if you are trying to accumulate a block?

A. That is right.

Q. Now, in policing a stock, what is the general technique and what is the method of handling the account?

A. In policing an account, you purchase it when sellers appear, and sell stock when buyers appear, and try to keep an orderly market \* \* \*.

Q. Now, suppose that the market was rising?

A. In other stocks?

Q. In your own stock?

A. Yes.

Q. Would you step in, in that sort of a situation, if you were merely policing the issue?

A. I would, and sell.

\* \* \* \* \*

Q. \* \* \* there must be some distinct and distinguishing technique in those situations.

A. There is.

Q. The techniques differ with respect to making new highs, isn't that so?

A. That is right.

Q. Now, if you are interested in policing an account, your primary purpose isn't to make new highs, is it?

A. Not unless the particular issue is sluggish and lagging behind the rest of the market, and then you may buy a certain number of shares to try to put it in line with the rest of the oil stocks.

Q. \* \* \* That isn't what we ordinarily mean by, for instance, an issuer or a corporation policing a stock where they are just going in to see that the market isn't demoralized or that it is a bad market, with big swings, isn't that so?

A. That is right \* \* \*.

The accounts on Prairie Oil & Gas stock present a similar picture. Mr. Cutten testified:<sup>70</sup>

Q. You will notice the Prairie Oil & Gas shows while not quite a similar picture, this [indicating] is the volume here. When did they buy Prairie Oil and Gas? It was on the 26th or 27th when there was a maximum volume that Blair & Company purchased the 28,000 shares. That was an awful lot of shares of Prairie Oil and Gas. That had a lot to do with the subsequent price. You won't deny that?

A. It did. You can see it on the chart.

Q. That is almost a scientific correlation, isn't that correct?

A. That is correct \* \* \*.

Q. I will just read you, Mr. Cutten the dates upon which the trading account in the Oil and Gas made highs: December 5th, 62 $\frac{5}{8}$ ; December 20th, 63 $\frac{1}{2}$ ; December 21st, 62; January 14th, 63 $\frac{7}{8}$ ; January 15th, 63 $\frac{5}{8}$ ; January 16th, 63 $\frac{1}{2}$ ; January 19th, 64; January 21st, the day on which the contract was consummated it made a high not only for that day but for this period of 65; January 23d, 63 $\frac{3}{4}$ ; January 24th, 62 $\frac{3}{4}$ ; \* \* \*: January 31st, 60 $\frac{1}{2}$ ; February 1st, 60 $\frac{1}{2}$ ; February 4th, 62 $\frac{1}{2}$ . They stopped on the 4th, but then the Petroleum Corporation of America picked it up on February 5th.

These characteristics of the Prairie accounts, Mr. Cutten conceded, were not those of mere "policing" accounts.<sup>71</sup>

Q. \* \* \* If an account was making or buying at high, almost every day, would you say that was a policing account?

A. No.

Q. And if an account was doing a very substantial portion of the total trading, would you say that was a policing account?

A. No.

Q. \* \* \* ordinarily in a policing account, is there any limitation placed upon the maximum commitment that you could take or the maximum short position that you could take, in those policing accounts? \* \* \*

A. They should have maximum on what he [the floor trader] could do.

Q. But it never takes the formidable form of a Syndicate Agreement, does it?

A. Very seldom.

\* \* \* \* \*

Q. Does it ever take the formidable form of having two accounts in one stock, and two accounts in the other, whether they are running concurrently?

A. I would not think so.<sup>72</sup>

While it is evident that the trading accounts were not mere policing accounts as Hunter Marston and Elisha Walker contended, it is also apparent from the records of the accounts that no attempt was being made by the syndicate manager to effect a wide market distribution of the stock to the public, as was being done at the time with the Sinclair Consolidated stock. As Elisha Walker testified, all of the members of the Syndicate were in agreement that to attempt another large market distribution concurrent with the Sinclair Syndicate would have been excessive and unwise. Mr. Walker stated:<sup>73</sup>

<sup>70</sup> Id., at 3130-2.

<sup>71</sup> Id., at 3110.

<sup>72</sup> At another point Mr. Cutten testified (id., at 3109):

Q. He [a person policing an issue] isn't interested in stimulating interest in the account, is he?

A. No.

<sup>73</sup> Id., at 3049.

I think in this particular case everybody felt that they had made an exceptionally favorable deal in the Prairie Pipe Line stock. The Prairie Pipe Line stocks had this perfectly enormous quick assets. I have forgotten what they were. And it had this large earning power. It was just one of those things that looked like to me a proposition that was very attractive for a profit, and at this time this particular group was really interested in the disposition of the [Sinclair] Consolidated Oil stock which it owned. That is the reason their attention was not focused, market-wise, on these stocks: it was focused on the distribution of the Consolidated Oil stock, and I think it would have been too ~~much~~ to even think of it, market-wise, to handle, two big operations such as was intimated might have been the situation here.

I am certain that the thought in the back of the bankers' minds was that if there was a public distribution it would be made by public offering and not by a stock market operation.<sup>74</sup>

It is patent that in the case of the Prairie stocks, Mr. Sinclair and his bankers had no intention of permitting these important large blocks of Prairie stock to be broken up but instead had conceived another and more advantageous formula for their disposal.

The plan which Messrs. Walker, Sinclair, and their associates had formulated for the disposition of the Prairie stocks was one which would enable them to realize a profit on these blocks as effectively as was done by the Sinclair Syndicate. In addition, the plan possessed one advantage of transcendent importance: it permitted these individuals in effect to retain control of the blocks of stock which they sold. The instrumentality devised for the accomplishment of this plan was Petroleum Corporation of America.

### **E. Purchase by Petroleum Corporation of America of Prairie Stocks at \$6,500,000 Profit to Syndicate**

In the early part of January, although the trading accounts in both Prairie stocks were effecting a large percentage of the total exchange trading, the prices of both stocks kept persistently backing away from the highs.<sup>75</sup> It was evident from the action of the market that the price of the Prairie stock could not be advanced much further without great difficulty. Moreover, interest charges on the Rockefeller loan were accumulating and the time for repayment of the loan was rapidly approaching.

<sup>74</sup> Ruloff Cutten likewise affirmed that no attempt was being made to distribute the stock market-wise. He stated (id., at 3133):

A. \* \* \* I was never called in to make a market operation out of it, and I do believe that since Mr. Hutton had the same percentage here he had in [Sinclair] Consolidated, and I was handling Consolidated, that undoubtedly I would have been given something to do in the Prairies, which I was not.

Q. Did you get instructions to move it [Prairie Oil & Gas] up to 60 and keep it there for a period of time?

A. I don't recall any of it. I don't recall trading in the stock more than a half dozen times myself, because I was so active in the Sinclair Oil on the floor of the Stock Exchange. I do know this from my experience, where the stock became active there and we were trading in 20,000 shares, say, in one day, had I been the man trying to dispose of that stock to the public I think it would have been close to 120,000 shares traded in that day.

<sup>75</sup> Prairie Pipe (new) backed off from a high of 56½ on January 2 to a low of 53½ on January 8. Prairie Oil and Gas dropped from 65½ on January 2 to 59½ on January 11.

Under these circumstances, on January 16, 1929, the Prairie Syndicate caused the formation of Petroleum Corporation of America.<sup>76</sup> Five days after its incorporation, Petroleum Corporation purchased from the Syndicate its holdings of Prairie Oil & Gas and Prairie Pipe Line stocks at prices which yielded the Syndicate a gross profit in excess of \$6,500,000. This profit, equal to approximately 49% on the Syndicate's cash investment of \$13,410,872, was realized in a period of less than two months from the date of the Syndicate's acquisition of these blocks of stock.<sup>77</sup>

The offering prospectus of Petroleum Corporation, after stating that the Corporation had been organized under the laws of Delaware for the purpose " \* \* \* of acquiring capital stocks of representative oil companies," added:

The Corporation proposes to acquire from a Syndicate in which Blair & Co., Inc., and others participating in the underwriting of this issue are members, approximately 300,000 shares of stock of the Prairie Oil and Gas Company at \$60 per share and approximately 550,000 shares of stock of the Prairie Pipe Line Company at \$52 per share, these prices being below present market prices but in excess of cost to the Syndicate. These two companies are of the so-called Standard Oil Group, and each is among the outstanding companies in its branch of the oil industry. Each has been in operation for many years and has accumulated a large surplus. The stocks of both are listed on the New York Stock Exchange.

The Prairie Pipe Line stock which Petroleum Corporation was purchasing for \$52 per share had cost the Syndicate \$42 per share on November 26, 1928 (equivalent to \$210 before the five for one split-up), and has sold on the market earlier that same month for \$41<sup>5</sup>/<sub>8</sub>, in September for \$36<sup>1</sup>/<sub>2</sub>, and in August for \$34<sup>3</sup>/<sub>8</sub>. During the month of January 1929, however, the stock had held steadily between \$56 and \$53<sup>3</sup>/<sub>4</sub> and had never been permitted to fall below the latter figure. On January 21, the date of the public offering of Petroleum Corporation stock, Prairie Pipe reached a new high of \$57, which it maintained the

<sup>76</sup> Petroleum Corporation of America was incorporated under the laws of Delaware. With respect to the genesis of the plan for the formation of Petroleum Corporation, Elisha Walker testified (op. cit. supra, note 1, at 2888):

Q. When was the first talk about forming this investment company, the Petroleum Corporation; do you remember?

A. That is a very difficult question, because the thought of investment trusts was so much in peoples' minds, not alone by our firm but by all sorts of firms. We naturally had thought, but when they crystallized actually into the Petroleum Corporation it would be very difficult for me to say.

Q. Now, you said that the people were thinking of investment trusts. Investment trusts' securities and certificates at that time were popular?

A. Yes.

Q. You might have less difficulty distributing \$45,000,000 worth of investment trust certificates than you would have in distributing \$45,000,000 worth of oil stocks at that time: wasn't that so?

A. I wouldn't say that \* \* \*.

<sup>77</sup> Hunter Marston testified (id., at 2810, 2819):

Q. \* \* \* the aggregate price received by the purchase group from the Petroleum Corporation of America was \$43,459,782.04, which left a gross profit of \$6,243,388. You recall you made approximately 6<sup>1</sup>/<sub>2</sub> million dollars on the sale of that stock?

A. I believe the group made somewhere around 6<sup>1</sup>/<sub>2</sub> million dollars, as I recall.

Q. In addition to that, part of that stock was sold to E. F. Hutton & Company (to cover short position in Prairie Pipe Syndicate account; see infra) and there was an additional profit on that, so that the aggregate profit \* \* \* was \$6,525,888, of which profit \$6,243,388 came from the Petroleum Corporation of America.

A. I assume those figures are correct.

Q. \* \* \* and that 6<sup>1</sup>/<sub>2</sub> million dollar profit was made on an advance by the purchase group of approximately \$13,000,000? Isn't that so? Because the \$25,000,000 that was borrowed from the Rockefeller interests to carry that purchase was repaid to the Rockefellers from the money that was received from the Petroleum Corporation of America when they bought that stock from the purchase group?

A. I believe that is correct, sir.

following day (January 22) and then eased off to \$54 $\frac{1}{8}$  at the end of the month. Thus, the price of \$52 per share (on the basis of the split-up stock) at which Petroleum Corporation purchased Prairie Pipe from the Syndicate was, on January 21 and January 22, \$5 per share (\$25 per share on the basis of the old stock) lower than the market quotation on those days, but it was \$10 per share (\$50 per share on the old stock) higher than the price the Syndicate had paid less than two months earlier and \$17 $\frac{5}{8}$  per share (\$88 $\frac{1}{8}$  on the old basis) higher than the market in August 1928.

The Prairie Oil & Gas stock which Petroleum Corporation was purchasing from the Syndicate for \$60 per share had on November 26, 1928, cost the Syndicate \$57 per share and earlier that same month had sold on the market for \$52 $\frac{5}{8}$  and for \$46 $\frac{3}{8}$  within the preceding month. During the important month of January 1929 the market price fluctuated between \$59 $\frac{1}{4}$  and \$65 and on the 21st and 22d of January had sold at \$65 and \$64 $\frac{1}{2}$  respectively. Thus the price of \$60 at which Petroleum Corporation purchased the Prairie Oil & Gas stock was, on January 21, \$5 below the market price on that day, but the price was \$3 higher than the Syndicate had paid less than two months earlier and \$13 $\frac{5}{8}$  per share higher than the price at which the stock had sold in October.

While literally true, the laconic statement that "these prices are below market but in excess of cost to the Syndicate," was disingenuously silent on two important questions:

1. Was the market price of the Prairie stock on January 21st and 22d, 1929, a free and untrammelled market price or was it inflated by pool manipulation?

2. How much in excess of the cost to the Syndicate were the prices at which the Corporation was purchasing these blocks?

Before this Commission, Elisha Walker answered the first of these questions as follows:<sup>78</sup>

Q. Of course, Mr. Walker, when we talk about this price being below the present market price, there is no disclosure that two trading accounts were acting in Prairie Oil and Gas and two in Prairie Pipe Line?

A. There is no mention in this letter.

Q. And no mention in the circular?

A. That is what I mean, in the circular.

In answer to the second question, Mr. Walker testified:<sup>79</sup>

Q. Now, other than "this price being below the present market price" there was no disclosure what the bankers paid for that stock, was there?

A. Except the statement they paid less for it.

Q. Well, less could be a thousand dollars or ten thousand dollars, or could be as much as six and a half million dollars, which it was?

A. Yes.

In January 1929, however, when Petroleum Corporation of America was purchasing this aggregate of \$46,600,000<sup>80</sup> worth of Prairie Pipe and Prairie Oil & Gas stock from the syndicate, there was no person to put these relevant questions to the sellers on behalf of Petroleum Corporation or its prospective stockholders. Blair & Co.,

<sup>78</sup> *Op cit. supra*, note 1, at 2907.

<sup>79</sup> *Id.*, at 2906.

<sup>80</sup> 300,000 Prairie Oil & Gas, at \$60-----	\$18, 000, 000
550,000 Prairie Pipe Line, at \$52-----	28, 600, 000
	<hr/> 46, 600, 000

Inc., and associates were the sellers and Blair & Co., Inc., and associates represented the buyers. Mr. Walker testified:<sup>81</sup>

Q. When it was determined to sell the \$38,000,000 worth of stock to an investment company to be formed, who carried on the negotiations to fix the price which would be paid by the investment company to be formed for the stock which the Purchase Group had bought from the Rockefeller interests?

A. I suppose that was before even the Board was actually chosen, and I suppose it just had been figured "well, the market is so and so, and this is the price. Is this all right?" I imagine it was worked out by Blair & Co. and their associates as to what was the proper price to put this in.

Q. That is, Blair & Co. sat down to determine what was the fair price for that stock and at what price they were to sell it to the investment company?

A. Blair and associates.

Q. By associates you mean persons in the Purchasing Group who bought the stock; that was Sinclair, Chase, Mr. Albert Wiggin, and those people?

A. Yes.

Q. And they determined that a \$50 increase on a \$210 stock was fair, and \$3 on a \$57 stock was fair?

A. I don't think that was the basis, as to what profit was fair, but what was the price. A man may buy a thing for ten cents and sell it for a dollar and make 900% profit, but that doesn't say that it wasn't worth a dollar. I don't think you should be quite that hard in your questions.

Q. I am not trying to be hard. I am trying to figure out the mechanics.

A. Yes.

Q. Here is Blair & Co., Mr. Sinclair and Mr. Chase, who bought this stock November 26, 1928, and then determined to organize an investment company where Blair & Co. are the sponsors and I assume who have a fiduciary duty with respect to the stockholders in that company. Isn't that true?

A. They owe a duty; yes.

Q. That same group determines at what price the investment company is going to purchase; wasn't that the fact?

A. Yes. Of course, an independent Board had to approve it, didn't they, or it never could have been bought.

Q. This prospectus states specifically that they proposed to acquire that at that price. Had the Board of Directors met before this preliminary draft of the circular was prepared?

A. That is what I can't answer. I really don't know when the Board had its first meeting. I know there was an informal meeting of the Board of Directors even prior to the regular Board meeting. When that was, I can't answer.

\* \* \* \* \*

Q. Looking back in retrospect, don't you find any difficulty in that situation?

A. In what respect?

Q. Well, here is a group that purchased a block of stock from the Rockefeller interests and fixed a price at which it was going to be sold to the investment company that was to be organized by the very persons who bought the block of stock from the Rockefeller interests and were selling it to that investment company. Do you have any difficulty with the concept that you were really on both sides of that transaction?

A. I think if you put this back in 1929, before we had any Securities and Exchange Commission, and will compare this with almost any other quotation that was made, where it states exactly the amounts and the prices of the stocks

<sup>81</sup> Op. cit. supra, note 1, at 2916.



that are being acquired, that the insiders are making a profit on it, I think it would be most unusual, certainly in those days, to recite what your profit was. They had taken their business risk of at least, roughly, two months. I think you have got to put everything in its own environment. There was no requirement in those times to publish what your own costs were and so forth.

Q. That is what I say. I am trying to draw a lesson from the experience.

A. I am a great believer in publicity, and I think what is being done today is a grand thing.

Q. Isn't it a question of more than believing in publicity? Do you think a person ought to be able to put himself in a position, publicity or no publicity, where he puts himself on both sides of a transaction that is of pecuniary interest to him?

A. I don't see how, where a corporation is formed by a banking house to take over certain securities in which the banking house has an interest, how it can be otherwise, very well, so long as the thing is stated publicly and frankly what it is.

Q. Let us see. Do you think the public would have been as prone to buy these securities had they known that the Purchase Group of the Rockefeller stock was making a six-and-a-half-million-dollar profit on a \$38,000,000 investment on which the bankers only had to put up \$13,000,000?

A. They took a commitment for \$38,000,000, didn't they, whether they borrowed \$25,000,000 or not, is another matter \* \* \*.

Hunter Marston,<sup>82</sup> Elisha Walker,<sup>83</sup> and Ruloff Cutten,<sup>84</sup> each in turn, in the hearings before this Commission, stressed that the sale to the investment company, although it yielded a large profit to the Syndicate, was "below the market." Mr. Cutten, when questioned on the subject, testified:<sup>85</sup>

Q. Of course, the statement that it is below the market price might mean a lot of things, isn't that so? It might mean that it is a bona fide purchase, and the public are not familiar with the fact that that is a market made by the persons interested?

A. It means exactly what it says, it was below the market price.

Q. But it does not say how the market price got there?

A. No.

In the course of the public examination an analysis of the daily price range and the volume of trading in the Prairie stocks (Chart 3) just prior to the public announcement of the sale of these securities to Petroleum Corporation resulted in some significant disclosures. With regard to the Prairie Pipe account, Ruloff Cutten testified:<sup>86</sup>

Q. The record indicates that you traded at high on the 17th, on the 18th, on the 19th, and high on the 21st, the high on the 24th, \* \* \* the high on the 27th, the high on the 31st, and the high on January 2d and the high on January 8th and the high on January 9th and the high on January 14th and the high on January 15th and the high on January 16th and the high on January 19th and that was getting pretty close to the time when they were going to make the announcement that they were going to sell Prairie Corporation, this Prairie Pipe and Oil stock, isn't that so?

A. I don't recall that date.

<sup>82</sup> Id., at 2819.

<sup>83</sup> Id., at 2906.

<sup>84</sup> Id., at 3130.

<sup>85</sup> Ibid.

<sup>86</sup> Id., at 3126.

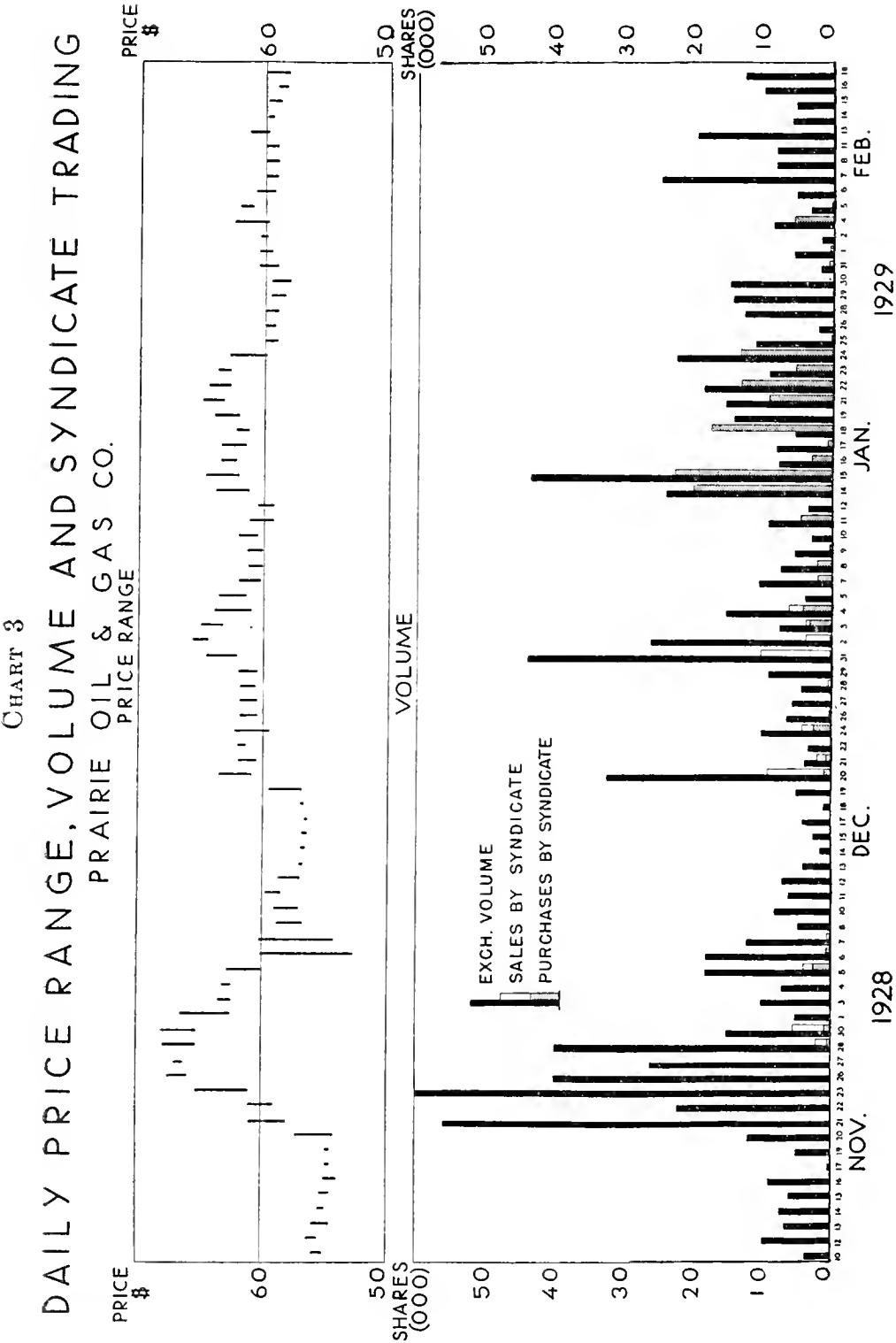
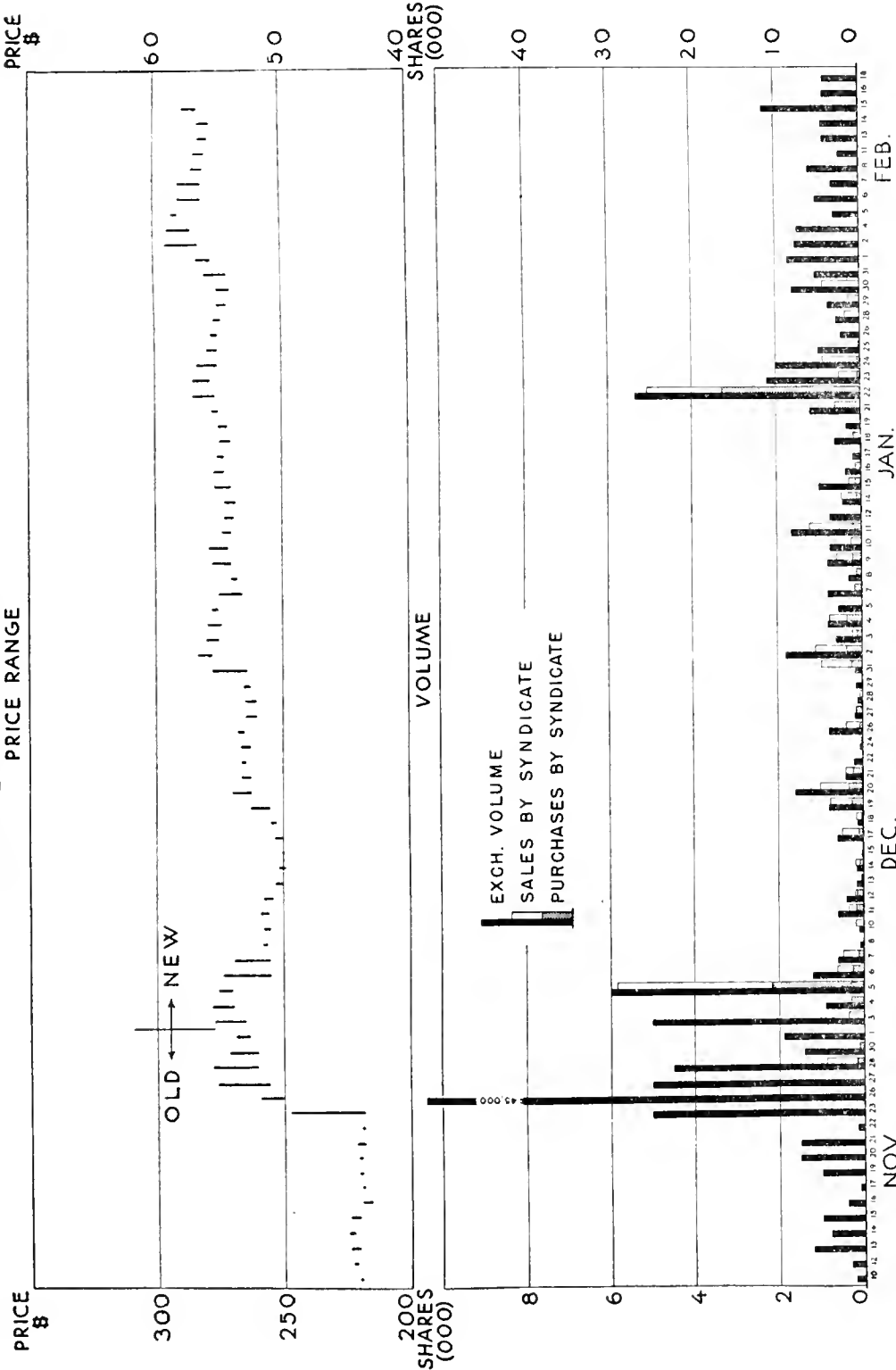


CHART 3—Continued  
PRAIRIE PIPE LINE CO.  
PRICE RANGE



1928 1929  
NOV. DEC. JAN. FEB.  
SOURCE: Public examination, Petroleum Corporation of America, Commissioner' Exhibit No. 351.

Q. January 21st and 22d. and then on the 23d. and then you stopped trading, according to our records, on the 25th. But on the 22d you made a new high of 57, and on the 23d you had 57.

Now, you won't deny, Mr. Cutten, that the market price at least at that period was being made by that trading account, will you?

A. Naturally, it had something to do with it if I actually bought the stock at the high, of course, that would be right.

Mr. Cutten also testified:<sup>87</sup>

Q. Now, you notice another curious thing, do you not, that on January 21, and January 22 and January 23, which was the date that Mr. Markham wrote the letter to Blair & Company setting forth the terms under which they were going to sell that substantial block of stock to Petroleum Corporation, there is a sudden burst of activity by the trading account, isn't that so?

A. Yes.

Q. And about that time you have a little upswing in the price?

A. Yes.

Q. Now, you won't deny that the trading of the account may have contributed a trifle to that increase in price, would you?

A. No; I wouldn't \* \* \*.

Q. Now, will you please tell us why it was necessary on the exact day that the announcement was being made to the public that the investment trust, Petroleum Corporation, was going to buy that block of stock, to do that substantial bit of trading on that day, if the purpose was merely to police the stock?

A. I am sure that I couldn't do that, as I say, I didn't do that active trading myself.

The records of the accounts established the fact that the Prairie Oil & Gas account from January 15 to January 28, 1929, had purchased approximately 169,000 shares of Prairie Oil & Gas and had disposed of less than 24,000 shares.<sup>88</sup> Mr. Cutten was asked:<sup>89</sup>

Q. Doesn't it look to you as if they were trying to peg that price around 60?

A. I wouldn't use the word "peg"; no.

Q. What expression would you use, stabilize?

A. Maintain the market around 60.

Q. That is the price at which it ultimately was sold to the Petroleum Corporation?

A. Correct.

## **F. Further Profits of \$1,883,862 Realized by Prairie Syndicate; Underwriting Contract With Blair & Co., Inc., and Payment of \$9,750,000 Fee; Public Distribution of Petroleum Corporation's Stock**

The \$6,500,000 profit realized by the Syndicate on the sale of the Prairie stocks to Petroleum Corporation constituted only one item of the profits and benefits which Petroleum Corporation's sponsors were to derive from their association with that corporation.

Elisha Walker, president of Blair & Co., Inc., was immediately constituted chairman of the board of directors of the newly formed

<sup>87</sup> Id., at 3123-4.

<sup>88</sup> Id., Commission's Exhibit No. 348.

<sup>89</sup> Id., at 3132.

investment company, Petroleum Corporation of America, and John H. Markham, Jr., described by Walker<sup>90</sup> as "a friend of Sinclair, a friend of Standard and various companies" was selected by Blair & Co. to be president.<sup>91</sup>

On January 21, 1929, the day on which the Syndicate sold to Petroleum Corporation the stock of the Prairie companies, the new corporation, without waiting for the formality of a meeting of the board of directors, entered into an underwriting agreement with Blair & Co., Inc., which resulted in payment to the sponsors and their associates of an additional \$9,750,000 as a fee for the distribution of Petroleum Corporation's securities.<sup>92</sup>

The underwriting agreement between Petroleum Corporation of America and Blair & Co., Inc., dated January 21, 1929,<sup>93</sup> provided that out of a total of 3,250,000 shares of stock which the corporation was to issue, Blair & Co. would purchase or procure purchasers for 650,000 shares of stock (20% of the amount to be issued) at \$34 per share. Of this \$34 price, \$20 was to be paid on delivery of the certificates for part-paid shares, and the balance of \$14 on call, but not before April 1, 1929, on 30 days' notice. With respect to the remaining 2,600,000 shares of stock to be issued, Blair & Co. made no firm commitment to purchase these shares but agreed merely to use its "best efforts" to procure purchasers at the same price and terms. Blair & Co. was to be paid \$3 per share for every share sold, or a gross spread of almost 10% on the net proceeds to the company. In addition, Blair & Co. was to receive for every two shares of stock sold one option warrant to purchase one share of stock at \$34, the issue price, exercisable within a period of five years. No distinction was made between the commission payable on the 650,000 shares for which Blair & Co. made a firm commitment, and the 2,600,000 shares as to which they merely agreed to use their "best efforts."<sup>94</sup>

Under this contract, the obligation of Blair & Co. to purchase was limited to 650,000 shares, but its opportunity for gain, without ob-

<sup>90</sup> *Id.*, at 2915.

<sup>91</sup> Mr. Markham had been one of the participants in the Sinclair Consolidated Trading Account. (Op. cit. *supra*, note 31, Part 6, Committee Exhibit No. 115, p. 3094.)

<sup>92</sup> The authorized capitalization consisted of 10,000,000 shares of no par stock, all of one class and each share entitled to one vote. The charter provided that the stockholders would have no preemptive right of any kind. The board of directors was given the right to determine the consideration, amounts, etc., for which the stock was to be issued, and could grant warrants or options therefor "for such consideration and on such terms and conditions as the board of directors in its sole discretion may determine."

The original offering to the public was 3,250,000 shares of stock at \$34 per share. An additional 1,625,000 shares were reserved for the exercise of warrant options. On April 27, 1932, the authorized capitalization was reduced to 4,600,000 no par shares and in 1933 the corporation's certificate of incorporation was further amended to provide that each share should have a par value of \$5. On April 24, 1935, the authorized number of shares was reduced to 2,200,000 with a par value of \$5.

<sup>93</sup> Op. cit. *supra*, note 1, Commission's Exhibit No. 328.

<sup>94</sup> *Ibid.* The Corporation reserved the right to terminate the contract by written notice at any time after July 1, 1929, if Blair & Co. had not by that date found purchasers for the 2,600,000 shares of stock for which they promised to use their "best efforts," but such termination was not to affect the rights of Blair & Co. Inc. in the sales which had been made prior to the termination. Thus, even though Blair & Co. failed to find purchasers for the entire 2,600,000 shares, it would receive full commission and option warrants for every share it did sell. The Corporation, on the other hand, would be left with the unmarketed securities which presumably could not again be offered to the public until some time had elapsed, and the corporation's financing would be left incomplete.

ligation, embraced an additional 2,600,000 shares.<sup>95</sup> Elisha Walker, however, was of the opinion that the distinction between a firm commitment and a mere option was "the bunk." He testified:<sup>96</sup>

Q. As to the matter of liability. In the one case you have a liability to take up \$100,000,000 worth of stock?

A. Yes.

Q. And in the other case you only have the obligation or liability with respect to \$20,000,000, isn't that so?

A. Yes.

Q. Then you have absolutely no liability as to the balance?

A. I say a banking house has a practical obligation the minute they put out this circular with 3,250,000 shares on it \* \* \*.

Q. Under those circumstances, then, it is simple, is it not, that there should have been a firm commitment in the first instance?

A. I have always said for years this "use your best efforts" contract is the bunk, if you will pardon the word, because a banking house can't get away with it.

Q. It is getting away to the extent they won't have to meet an eighty-million-dollar (\$80,000,000) obligation?

A. Technically, yes, but practically, no. If the 650,000 shares had been issued with the statement that there was an option on the balance, then the bankers could have taken down any number at all, but when they once put their name on the 3,250,000 shares, practically speaking, for their own reputation's sake, they had to go through with it.

The contract between Blair & Co. and Petroleum Corporation of America provided further that the entire commission of \$3 per share was payable to Blair & Co. as soon as the first installment payment of \$20 was made on the stock; and Petroleum Corporation of America assumed the task and the risk of collecting the \$14 balance, without recourse to Blair & Co. even for a partial refund of the fully paid commission in case purchasers failed to pay the balance.<sup>97</sup> Elisha Walker asserted in justification of this arrangement that a great many securities had been sold on this basis and "it is very popular in England."<sup>98</sup>

To aid it in the distribution of Petroleum Corporation's shares, Blair & Co. organized three groups:<sup>99</sup> a "Purchase Group,"<sup>100</sup> a

<sup>95</sup> Elisha Walker conceded that as to the 2,600,000 shares the arrangement actually constituted the grant of an exclusive agency to Blair & Co., Inc. to sell the shares at \$34 per share. (Id., at 2925.)

<sup>96</sup> Id., at 2928.

<sup>97</sup> That this was not merely an illusory risk is evidenced by the fact that although the corporation on June 30, 1929, issued a call for the \$14 balance on the stock payable October 1, 1929, at the end of December 1929, \$1,106,555 remained unpaid. Ultimately, on January 29, 1936, shares representing a balance of \$104,484 remaining unpaid were sold by the corporation at public auction. (Id., at 2930, and the reply to the Commission's questionnaire for Petroleum Corporation of America.)

<sup>98</sup> Op. cit. supra, note 1, at 2930.

<sup>99</sup> The \$3 underwriting commission received by Blair & Co. was divided among these groups as follows: 62½ cents to the "Purchase Group," 62½ cents to the "Banking Group," and \$1.75 to the "Selling Group". (Op. cit. supra, note 1, Commission's Exhibit No. 338.)

<sup>100</sup> The "Purchase Group" was made up of 34 members, among whom were Bancamerica-Blair Corporation, Transamerica Corporation, Shermar Corporation, Chase Securities Corporation, Haystone Securities Corporation, E. W. Hutton & Company and Harry F. Sinclair. This group divided net profits, after all expenses, of \$1,856,085. (Derived from supplementary information supplied the Commission for Petroleum Corporation of America.)

"Banking Group,"<sup>101</sup> and a "Selling Group,"<sup>102</sup> consisting of bankers, brokers, and security dealers located in every section of the country, totaling together more than 800 different participants. Out of the total of \$9,750,000 in commissions paid to the groups concerned in the distribution, \$1,883,862 was paid, because of their participation in various of these distributing groups, to those who formed the original Prairie Syndicate.<sup>103</sup> The aggregate profit of the syndicate members resulting from their initial association with Petroleum Corporation of America was thus increased to approximately \$8,300,000.<sup>104</sup>

The stock of Petroleum Corporation of America was offered to the public through the Selling Group on January 22, 1929, and \$65,000,000, less commission, or a net sum of \$55,250,000 was paid immediately to the corporation. On June 30, 1929, the \$14 balance per share, totaling \$45,000,000, was called for payment on October 1, 1929. At the end

<sup>101</sup> The "Banking Group" consisted of about 340 participants, among whom were many members of the "Purchase Group." This group assumed the liability for a market trading account, which was established by Blair & Co., Inc., on February 5, 1929, the take-down date of the stock, for the purpose of "stabilizing" the market. The net commission of \$3,088,281 earned by the Banking Group was credited to the cost of the 629,095 shares of Petroleum Corporation stock remaining in the stabilizing account when it was terminated June 3, 1929. With respect to this stabilizing account, Elisha Walker testified (op. cit. supra, note 1, at 3044):

Q. In connection with the underwriting of the Petroleum Corporation stock, there was, shall we call it, a trading or stabilizing account, in Petroleum Corporation, run by the banking group, do you recall?

A. You mean after the stock was sold, the syndicate maintained the market in the stock?

Q. Yes.

A. If I remember correctly, yes.

Q. Do you remember what the experience of the account was?

A. If I remember correctly, the stock was all disposed of in the first instance, and then the stock started to come back into the market, and the syndicate protected that market and bought back quite a substantial amount of the stock.

Q. It had to buy back approximately 800,000 shares of Petroleum Corporation; isn't that so?

A. I had forgotten it was as much as 800,000. I remember 500,000.

Q. Of course, the reason you recall 500,000 was because 500,000 at that time was sold to Sinclair Consolidated Oil Corporation, isn't that so?

A. Yes, that is the reason I remember that.

The mechanics of the sale of the 500,000 shares of Petroleum Corporation to Sinclair and the manner in which it affected Petroleum Corporation are reviewed and discussed, infra.

<sup>102</sup> The "Selling Group" was composed of some 750 individuals, brokers, investment bankers and dealers in securities, including some of the largest and some of the smallest. The net profit distributed to this group, after deduction of \$1,195,031 representing penalties for repurchased stock, amounted to \$4,106,068. (Derived from supplementary information supplied the Commission for Petroleum Corporation of America.)

<sup>103</sup> Most of the Prairie syndicate members received participations in each of the three groups. Several of them, however, did not participate in the Banking Group. Listed below is the total sum paid to each:

Bancamerica-Blair Corporation-----	\$1, 031, 263
Arthur W. Cutten-----	236, 088
Harry F. Sinclair-----	140, 576
Chase Securities Corporation-----	94, 614
Shermar Corporation-----	27, 985
Famoth Corporation }	
Traywin Corporation }	67, 284
E. R. Tinker-----	19, 913
Haystone Securities Corporation-----	172, 748
Equitable Trust Co-----	57, 054
C. O. Kalman (and Kalman & Co.)-----	36, 337

1, 883, 862

These additional profits received by the members of the Prairie syndicate do not include profits realized by inclusion on Blair & Company's preferred list or from warrants. These items are discussed infra, pp. 260-3.

<sup>104</sup> Approximately \$6,500,000 on the sale of the Prairie stocks plus \$1,883,862 as participants in the distributing groups.



of 1929 there remained unpaid \$1,106,555 of the sum called, but this unpaid balance was reduced to \$117,240 by the end of 1930. On January 29, 1936, Petroleum Corporation sold at public auction the shares of stock representing the balance still outstanding, for \$104,484.<sup>105</sup>

The public paid a total of \$110,500,000 for the 3,250,000 shares issued by Petroleum Corporation of America. Of this sum the Corporation, however, received only \$100,617,112. To the underwriters and distributors there was paid \$9,750,000 in commissions.<sup>106</sup> Moreover, under the terms of the underwriting contract the Corporation agreed at its own expense, to qualify the stock under the Blue Sky laws of the various states, to secure the listing of its stock on the various stock exchanges, and to pay all expenses of organization, including all issue and stamp taxes and including even the fees and disbursements of the underwriters' counsel.<sup>107</sup> These expenses totaled \$132,888.<sup>108</sup>

The commission paid to the underwriters by Petroleum Corporation of America was equivalent to 8.8% on the total gross price paid by the public, or 9.7% of the proceeds to the Corporation, before deducting expenses. On the initial cash payment of \$65,000,000, at which time the entire commission became payable,<sup>109</sup> it represented 15% of the sum actually paid by the public and 17.6% of the net proceeds to the Corporation. This commission, as has been pointed out, was paid under an underwriting contract in which the underwriter firmly committed itself only to the extent of 20% of the number of shares to be issued by the Corporation.

## 1. BLAIR & CO.'S LIST OF PREFERRED SUBSCRIBERS

From the original block of 650,000 shares of stock which under the underwriting contract it agreed to purchase, Blair & Co. sold 220,600 shares to a preferred list of 58 individuals and one corporation, at the price of \$31.25 per share, or \$2.75 per share under the public offering price of \$34.00. Of these 58 individuals, 41 were persons of prominence in various parts of the country who had accepted invitations from Blair & Co. to become directors of Petroleum Corporation of America, and whose names appeared in the circular offering the stock of Petroleum Corporation of America to the public on January 22, 1929. Of the remaining individuals, 14 were directors or officers of Blair & Co., Inc.<sup>110</sup>

<sup>105</sup> Reply to the Commission's questionnaire for Petroleum Corporation of America, Exhibit A, Schedule 19.

<sup>106</sup> *Id.*, Item 41. However, from this commission, Blair & Co. relinquished \$2.75 per share on a block of 220,600 shares, or a total of \$606,650, to a list of preferred subscribers, in the manner recounted *infra*, Sec. F, 1.

<sup>107</sup> Elisha Walker conceded that such a provision is not customary in underwriting contracts. Mr. Walker testified that ordinarily the company and the banker each pays its own legal expenses. (*Op. cit. supra*, note 1, at 2931.) Petroleum Corporation paid the sum of \$50,000 as legal expenses in connection with the issue of its stock. (Reply to the Commission's questionnaire for Petroleum Corporation of America, Item 44.) Mr. Walker identified the law firm to which the payment was made as Cravath, de Gersdoff, Swaine & Wood. (*Op. cit. supra*, note 1, at 2932.)

<sup>108</sup> Reply to the Commission's questionnaire for Petroleum Corporation of America, Item 44.

<sup>109</sup> See *supra*, pp. 258-9.

<sup>110</sup> For a complete list of these favored subscribers see Appendix C, p. 783.

## 2. DISTRIBUTION OF OPTION WARRANTS TO SPONSORS AND UNDERWRITING SYNDICATE

In addition to the gross spread of \$3 per share and as part of the compensation provided in the underwriting contract, Petroleum Corporation of America issued to Blair & Co. 1,625,000 option warrants to purchase the stock at \$34 per share, exercisable any time within five years from the date of issuance. In the prospectus it was stated that these option warrants were to be issued not only to the underwriters, but "to others who will become responsible for the management of the Corporation."<sup>111</sup> Blair & Co. allotted the options on the following basis: Purchase Group, 40%; Banking Group, 20%; Blair & Co., Inc., 15%; to "assist in procuring management," 25%.<sup>112</sup> Of the block of 406,250 warrants allotted to "assist in procuring management" 356,250 warrants went to the various members of the Prairie Syndicate.<sup>113</sup> The remaining 50,000 warrants were divided between Elisha Walker and John H. Markham, Jr., respectively chairman of the Board and president of Petroleum Corporation of America.<sup>114</sup>

All of the option warrants issued by Petroleum Corporation of America were tied up under an agreement giving Blair & Co., Inc. sole right to exercise or dispose of them on behalf of all the owners.<sup>115</sup> In 1930 the warrants were admitted to unlisted trading privileges on the New York Curb and Boston Stock Exchange,<sup>116</sup> and during that year approximately 140,700 warrants were traded on the New York Curb Exchange at prices ranging from \$5<sup>7</sup>/<sub>8</sub> to 50¢ per warrant.<sup>117</sup> As of November 10, 1931, a total of 201,700 warrants was sold to the firm

<sup>111</sup> Op. cit. supra, note 1, Commission's Exhibit No. 322.

<sup>112</sup> Id., Commission's Exhibit No. 338.

<sup>113</sup> These warrants were distributed as follows (derived from supplementary information supplied the Commission for Petroleum Corporation of America) :

	<i>Warrants</i>
Blair & Co., Inc.-----	66, 609
Arthur W. Cutten-----	66, 609
Harry F. Sinclair-----	66, 609
Chase Securities Corporation-----	44, 406
The Shermar Corporation-----	22, 203
Equitable Trust Co. of New York-----	6, 125
Continental National Corporation-----	6, 125
Traywin Corporation-----	5, 359
Famoth Corporation-----	5, 359
Haygart Corporation-----	1, 531
L. W. Hill and Kalman & Co-----	1, 531
Haystone Securities Corporation-----	1, 531
Reserved (Walker and Markham)-----	50, 000
Unallotted-----	12, 253
	356, 250

<sup>114</sup> Ibid. Elisha Walker testified (op. cit. supra, note 1, at 3040) :

Q. Now, the fact of the matter is that not a single option warrant went for management, isn't that so?

A. I couldn't answer that.

\* \* \* \* \*

Q. So that of the 1,625,000 option warrants, all but 50,000 shares, which went to John W. Markham, Jr., and yourself, went to the people who were in the purchase group of the Prairie Oil and Pipe stock, from the Rockefeller interests, isn't that so?

A. Were they passed along in turn by that group to others at all, did the directors get any special warrants?

Q. The directors got a special price in connection with the Petroleum Corporation of America stock, and you recall that they were sold minus the three dollar commission, isn't that so?

A. I have really forgotten that.

<sup>115</sup> Op. cit. supra, note 1, Commission's Exhibit No. 322.

<sup>116</sup> Reply to the Commission's questionnaire for Petroleum Corporation of America, Item 49.

<sup>117</sup> Op. cit. supra, note 1, at 2868.

of Bluchen & Co. for the aggregate sum of \$571,425.<sup>118</sup> This sum, and the remaining warrants, were distributed to the various firms and individuals to whom the warrants had been allotted.<sup>119</sup>

The option warrants expired on February 1, 1934, without any having been exercised, evidently for the reason that Petroleum Corporation stock at its 1929 high never rose above 34 $\frac{1}{8}$  per share, and eventually sunk to a low of 27 $\frac{7}{8}$ . Nevertheless, the underwriting group actually realized \$571,000 in cash from those warrants and, at 1930 prices, the warrants had a potential market value of \$812,500 at the low and \$9,500,000 at the high.<sup>120</sup>

By reason of the warrants issued to Blair & Co. the stockholders of Petroleum Corporation of America were confronted at the outset with the prospect that if their corporation were able to earn a profit on its capital, in the face of the \$9,750,000 paid over to the bankers for distributing its stock and the \$6,500,000 mark-up in the price of the Prairie stocks, then Blair & Co. and associates could declare themselves one-third partners with the original stockholders by the exercise of the warrants within five years at \$34 per share.<sup>121</sup>

<sup>118</sup> Id., at 2869.

<sup>119</sup> Members of the Prairie Syndicate received the following sums in cash and in addition, the number of option warrants enumerated (derived from supplementary information supplied the Commission for Petroleum Corporation of America :

	Cash proceeds distributed Nov. 10, 1931	Option warrants
Blair & Co., Inc. ....	\$177,056	453,352
Arthur W. Cutten .....	33,797	96,525
Harry F. Sinclair .....	42,763	118,860
Chase Securities Corporation .....	24,074	68,197
Shermar Corporation .....	12,037	34,099
Haystone Securities Corporation .....	14,283	35,861
Famoth Corporation .....	5,005	13,465
Traywin Corporation .....	5,005	13,465
Equitable Trust Co. of New York .....	7,722	20,369
	321,742	849,893

The balance of the money and the options were distributed among 353 others who had joined in the distribution of the securities.

<sup>120</sup> Op. cit. supra, note 1, at 2869.

<sup>121</sup> Hunter Marston testified (id., at 2865-9) :

Q. There were 1,600,000 option warrants issued to the bankers?

A. At \$34 to buy at the issue price.

Q. The bankers got one option warrant for every two shares sold?

A. I think the syndicate got that.

Q. The syndicate got it?

A. Yes.

Q. So that the syndicate was always in a position to dilute the equity of the stockholders one-third, isn't that so, by exercising these warrants?

A. Well, I hadn't figured it out, but evidently there would be that additional amount of stock issued at \$34 per share.

Q. For every two shares of stock sold the syndicate got one option warrant, and that meant if it were exercised there would be three shares outstanding of which the syndicate owned one.

A. But there would be additional capital in the company.

Q. I mean there is some basis of evaluating it, isn't that so? Here is an option warrant that was issued at the market price and that had five years to go. What would you say the value of such an option was if the price at which it is to be exercised was \$34? Would you say it is worth \$10?

A. I don't know.

\* \* \* \* \*

Q. There were traded in on the New York Stock Exchange approximately 140,700 warrants during 1930 at prices ranging from 5 $\frac{7}{8}$  dollars per warrant to 50¢ per warrant \* \* \* on the basis of that \$5 per warrant these 1,625,000 option warrants had a market value of 9 $\frac{1}{2}$  million dollars, isn't that so?

A. If you could sell them all.

Q. Well, there were 140,700 warrants traded in in 1930 after the market crash, isn't that so?

A. As I say, I don't recall without looking that up.

Moreover, these option warrants constituted an instrumentality for five years through which the warrant holders could maintain or reestablish control of the corporation.

### 3. DISTRIBUTION OF PROFITS OF THE PRAIRIE SYNDICATE

Under the terms of the contract dated January 21, 1929,<sup>122</sup> between Petroleum Corporation of America and Blair & Co., Inc., for the purchase of the Prairie stocks, Petroleum Corporation of America was bound only to purchase 57,000 shares of Prairie Oil & Gas, and 110,000 shares of Prairie Pipe. As to the balance of 243,000 shares of Prairie Oil & Gas, and 440,000 shares of Prairie Pipe, the Corporation took an option for 30 days.<sup>123</sup> Nevertheless, by February 6, 1929, the corporation had purchased and paid for the entire 300,000 shares of Prairie Oil & Gas stock and 550,000 shares of Prairie Pipe stock.<sup>124</sup> This prompt receipt of payment by the Prairie Syndicate permitted the Syndicate to clear its debt to John D. Rockefeller, Jr. by paying to him the sum of \$25,000,000. In addition, the syndicate paid to Rockefeller the sum of \$262,500 as accrued interest on the loan.<sup>125</sup>

<sup>122</sup> Id., Commission's Exhibit No. 331.

<sup>123</sup> Ibid. It was suggested at the examination before this Commission that the explanation for this form of contract is that since the underwriters had taken a firm commitment for only 650,000 shares, the corporation could not commit itself to take up the entire number of shares offered. (Id., at 2911.)

<sup>124</sup> Petroleum Corporation of America purchased from Blair & Co., Inc., representing the syndicate, 550,000 shares of Prairie Pipe and 247,796 shares of Prairie Oil & Gas. The balance of 52,204 shares of Prairie Oil & Gas needed to round out the block of 300,000 was obtained Feb. 5, 1929, for \$3,132,240 from the syndicate "B" account at E. F. Hutton & Co., which, as was stated supra in the discussion of that account, was long at that date a substantial amount of Prairie Oil & Gas stock.

<sup>125</sup> Op. cit. supra, note 1, Commission's Exhibit No. 333. An itemized statement of account of the Prairie purchase and sale by the syndicate is set forth below. For the table showing distribution of the profits to the individual participants, see Appendix D, p. 785.

Cost of stock to the group:

578,250 shares of The Prairie Pipe Line Company common stock (the old stock having been split up 4 for 1 on Jan. 4, 1929, and a dividend of 25% payable in the new \$25 par stock having been declared on Jan. 8, 1939)-----	\$24, 286, 500. 00
247,796 shares of The Prairie Oil & Gas Company common stock-----	14, 124, 372. 00

Total----- 38, 410, 872. 00

Sale to Petroleum Corporation of America:

550,000 The Prairie Pipe Line Company common stock at \$52 per share-----	\$28, 594, 500. 00
247,796 shares The Prairie Oil & Gas Company common stock at \$60 per share-----	14, 865, 282. 04
(The additional 52,204 shares necessary to make the block of 300,000 acquired by Petroleum were purchased from Syndicate B Trading Account.)	

Sale to syndicate and delivered to E. F. Hutton & Co. (to cover short position in Prairie Pipe Line Syndicate Account, see supra)----- 1, 469, 000. 00

Total proceeds from sales----- 44, 928, 782. 04

Gross profit to the group----- 6, 517, 910. 04

In addition to the profit to the group on the sale of stock to Petroleum Corporation of America, the profit made by the two syndicate accounts (the profit and loss accruing to the Trading accounts are excluded from this computation because they were run under different syndicate agreements, and included slightly different parties) and dividends increased the total gross profit to the group to \$6,645,169.30. Expenses, including interest of \$262,500 on the loan from John D. Rockefeller, Jr., counsel fees to Cravath, De Gersdorff, Swaine and Wood of \$81,493.24, and a payment to W. S. Fitzpatrick of \$130,000 (later increased to \$149,000) on account of a 2½% interest in the net profits, amounted to \$558,813.25.

In computing the profits realized by the members of the **Prairie Syndicate** in connection with the organization of **Petroleum Corporation of America**, it has already been shown that to the gross profit of \$6,645,169 gained by the syndicate on the sale of the **Prairie** stocks to the corporation there must be added \$1,883,862 received by the members of the syndicate in commissions as participants in the various selling groups<sup>126</sup> and \$321,742 received by members of the syndicate on the distribution of the proceeds of the option warrants account.<sup>127</sup> In addition, the group continued to own 849,893 option warrants,<sup>128</sup> which gave it the right for five years of declaring itself a participant in any stockholders' equity in excess of \$34 per share, and of reaffirming its control of the corporation should it be necessary. But after garnering these pecuniary benefits, there remained in the hands of members of the original group one benefit of perhaps even greater consequence—the effective control of **Petroleum Corporation of America**, with its \$100,000,000 of assets.

#### 4. PAYMENTS TO W. S. FITZPATRICK

The statement of expenses of the syndicate and the distribution of the profits indicates that \$149,000 was paid to one **William Samuel Fitzpatrick** out of the **Prairie Syndicate** profits,<sup>129</sup> and that an additional sum of \$300,053 was paid to **Fitzpatrick** by **Sinclair Consolidated Syndicate**.<sup>130</sup> These payments to **Fitzpatrick**, totaling \$449,052, represented 2½% participations in both the **Prairie Syndicate** and the **Sinclair Consolidated Oil Syndicate** which were granted to **Fitzpatrick** without either the investment of any money or the assumption of any liability on the part of **Fitzpatrick**.

The reasons why **Fitzpatrick** received this "soft thing," as he termed it, were developed in the examination before this Commission<sup>131</sup> and in the hearings before the Committee on Banking and Currency of the United States Senate.<sup>132</sup> **Fitzpatrick** was the president of **Prairie Oil & Gas Company** and, according to his statement,<sup>133</sup> had faithfully represented the interests of the **Rockefellers** in the **Prairie** companies for some twenty years. Early in 1928, **Fitzpatrick** heard that the **Rockefellers** were selling to **Blair & Co., Inc.**, all the holdings of the various **Rockefeller** trusts in these companies, which meant a 50% reduction of the **Rockefeller** influence in the **Prairie Companies**.<sup>134</sup> This information caused **Fitzpatrick** some concern. He took the first opportunity to discuss the matter with **Bertram Cutler**, the **Rockefeller** representative. **Fitzpatrick** said that **Cutler** told him:<sup>135</sup>

\* \* \* these people [the purchasers] would probably make a market or find a market for these shares. They did not suppose \* \* \* that they were

<sup>126</sup> Op. cit. supra, note 103.

<sup>127</sup> Op. cit. supra, note 119.

<sup>128</sup> Ibid.

<sup>129</sup> Op. cit. supra, note 1, at 3141.

<sup>130</sup> Op. cit. supra, note 32. (Of this sum, \$93,473 was prorated among the members of the **Prairie Syndicate** to take up stock in the **Sinclair Consolidated Oil Company** pool account which had been assigned in **Fitzpatrick**.) (Op. cit. supra, note 1, at 3143.)

<sup>131</sup> Op. cit. supra, note 1, at 2934-5, 3140, et seq.

<sup>132</sup> Op. cit. supra, note 31, Parts 6 and 7.

<sup>133</sup> Id., Part 7, p. 3309 et seq.

<sup>134</sup> Ibid.

<sup>135</sup> Ibid.

permanently investing in these oil companies, and they [the Rockefellers] had arranged with those people to, as they called it, do something for me.

Subsequently, Fitzpatrick testified that Hunter Marston of Blair & Co. told him that he would be "carried" for a 10% participation in the profits of the Prairie Syndicate, without any obligation on his part.<sup>136</sup> In the meantime, Fitzpatrick was meeting with Sinclair in negotiations for the merger of the Prairie companies with Sinclair Consolidated Oil.<sup>137</sup> In the course of their conferences Sinclair told Fitzpatrick that "he was negotiating, and expected to make a sale of the unissued treasury stock of the Sinclair company and get this money [\$33,000,000] in lieu of it."<sup>138</sup> Thereafter Mr. Fitzpatrick was told by Elisha Walker of Blair & Co., and by Edward Tinker, that he would be included in the Sinclair Syndicate as well as on the Prairie Syndicate. Mr. Fitzpatrick stated:<sup>139</sup>

A. \* \* \* I don't remember just what language they employed, but I was given in some way to understand that they were participants in that syndicate—yes; and that they—somebody—had arranged that I should have 2½%, along with the 2½% in the other syndicate, in lieu of the 10% that had been talked of between Mr. Marston and me. Now, how they arranged that I never asked. Nobody ever told me. Why they passed that on to the other syndicate I do not know. Frankly, gentlemen, I regarded the opportunity to share in these profits as a very fine thing for the Rockefellers to do and to arrange for me on account of the services I had rendered, and I had no other idea about it, and I did not care whether it was \$300,000—I had no idea it would be anything like that amount of money. I never dreamed that it would be anything like that amount of money. And I did not care how much it was, or how it was divided, or who got the rest of it, or anything about it. I was taking it and making very little inquiry about it.

Q. Did you feel at that time that the Rockefeller interests were under some kind of obligation, moral or otherwise, to give you something additional to the salary you had received for your twenty years' service?

A. I did not. I knew that Mr. Rockefeller, according to the press, was giving millions of dollars away to this thing and that thing, and I thought it was a very nice and lovely thing for Mr. Rockefeller to remember a faithful employee, as he seemed to be remembering me.<sup>140</sup>

<sup>136</sup> Fitzpatrick stated (id., at 3310): "Later on I was talking to Mr. Marston, of Blair & Co., and I don't know whether he brought the subject up or whether I did, but one or the other of us—the subject was talked of and I said, 'What do you mean?' He says, 'Carry you; have an interest in the profits we make on whatever distribution we make of this stock.' Then I said, 'What interest? How do you mean?' I am quite sure I explained to him that I did not want to incur any indebtedness, and he said, 'No; carry you for a share of the profits.' I said, 'What share? How?' He said, 'I presume, about 10 percent.' "

<sup>137</sup> Id., at 3313.

<sup>138</sup> Ibid. This was the sale to Cutten and the syndicate of the 1,130,000 shares of Consolidated Oil Corporation which were later distributed through pool operations, in the manner described supra.

<sup>139</sup> Id., at 3315.

<sup>140</sup> Harry F. Sinclair testified as follows concerning the payment to Fitzpatrick (op. cit. supra, note 31, Part 7, p. 3291):

Q. Blair & Co. had no greater interest in the syndicate than you had originally?

A. No.

Q. And no greater interest than Cutten had originally?

A. Correct.

Q. So that Blair & Co. were making him some money at the expense of all the other syndicate participants?

A. There is no doubt about that.

\* \* \* \* \*

Q. So that you were one of the Santa Clauses? This was a Santa Claus syndicate, so far as giving Fitzpatrick \$300,000 was concerned?

A. It sounds a bit like it, doesn't it?

Elisha Walker, while conceding that Bertram Cutler, the Rockefeller representative, had mentioned the matter to him, made it clear that the decision of the Prairie Syndicate to take care of Fitzpatrick was impelled by considerations in which mere amenities played no part. Mr. Walker testified with respect to the Fitzpatrick participation: <sup>141</sup>

We were under absolutely no obligations. But there are always business considerations. If we were going in to buy such an important interest in the Prairie Oil and Gas and Prairie Pipe Line Companies, we considered it important to have the management a satisfied and pleased management. Now, this was nothing unusual. It has been done in other transactions before of a similar nature.<sup>142</sup>

In this way, Blair & Co. and Sinclair endeavored to assure themselves of the good will of Fitzpatrick and the Prairie management, not only for the purposes of the Prairie market transactions, but in the negotiations for the consolidation of Sinclair Consolidated Oil Corporation and the Prairie companies. This good will they strengthened from time to time in various ways until the consolidation was achieved.<sup>143</sup> Mr. Fitzpatrick, however, for his part, never sought any subtle implications in his good fortune. He testified:<sup>144</sup>

Q. Was it your understanding that the profits were to be realized out of transactions in the common stock of the Sinclair Company?

A. Sure, sure. So far as I knew that was all that was involved in the deal.

Q. You may, or may not know it, but Mr. Sinclair yesterday referred to your receiving that \$300,000 as a "pretty soft thing." You would not dispute him in that respect, would you?

A. I certainly would not. [Laughter.] I so regarded it myself.

Q. Have any other "soft things" of that same character come your way?

A. Never have.

## G. Management and Policies of Petroleum Corporation of America—Domination by Sinclair and Bancamerica-Blair

Nothing in the charter of Petroleum Corporation of America or in the public announcements which accompanied the issuance and distribution of its stock even remotely indicated that the corporation was intended as a vehicle for advancing the plans of Sinclair and his banking associates to consolidate various oil companies into one large unit dominated by the Sinclair interests. On the contrary, the offering prospectus of Petroleum Corporation of America <sup>145</sup> referring to the Prairie stock purchase made pointed mention that "these two companies are of the so-called Standard Oil group," without disclosing

<sup>141</sup> Id., at 3333.

<sup>142</sup> Mr. Walker testified further on this subject (ibid.) :

Q. Why was it necessary, in your opinion as a banker who contemplated buying shares owned by the Rockefeller Foundation in the stock of the Prairie Co., to see to it that the servant of the corporation was satisfied to have you become a stockholder?

A. Well, just ordinary business of wanting—where you undertake a very important transaction mounting into a great many millions of dollars, that you want to be sure of the good will and the ability to work agreeably in the situation \* \* \*.

<sup>143</sup> See *infra*, pp. 281-5.

<sup>144</sup> Op. cit. *supra*, note 31, Part 7, p. 3318.

<sup>145</sup> Op. cit. *supra*, note 1, Commission's Exhibit No. 322.



that it was contemplated to make these Prairie companies part of the Sinclair system. This statement may have caused many of the prospective purchasers to believe that they were investing their money in "Standard Oil" companies managed by Standard Oil interests.<sup>146</sup> The long list of names prominent in the commercial and financial world which constituted Petroleum Corporation's initial board of directors did not include that of Harry Sinclair. For three years after Sinclair Consolidated Oil Corporation became Petroleum Corporation's largest stockholder<sup>147</sup> the name of Sinclair never appeared either as officer or director. In 1932, after the consolidation of the Prairie companies with Sinclair Consolidated Oil, Earl W. Sinclair accepted a directorship in Petroleum Corporation of America.

The Sinclair Consolidated Oil interests, however, were never lacking in adequate representation on Petroleum Corporation's board or directors. Of the original 45 directors, 5—Elisha Walker, Hunter S. Marston, George Armsby, Harry Bronner, and Leo V. Belden—were associated with Blair & Co., Inc., or Bancamerica-Blair Corporation, the Sinclair bankers.<sup>148</sup> Eight directors were, or became, directors of Sinclair Consolidated Oil Corporation, or Consolidated Oil Corporation. These were Elisha Walker, Hunter S. Marston, Arthur W. Cutten, Ruloff E. Cutten, Halstead G. Freeman, John H. Markham, Jr., H. H. Rogers, and Edward R. Tinker. The remaining 34 directors whose names originally appeared on Petroleum Corporation's unusually large board were men selected by Blair & Co., Inc., to lend greater prestige to the corporation in its first public appear-

<sup>146</sup> The Standard Oil Companies as Elisha Walker testified (*supra*) were regarded as "high-grade investment companies," while Sinclair Consolidated "had not the background that the Standard Oil subsidiaries had \* \* \* it was a comparatively new institution which had been growing and fighting its way \* \* \*". (*Op. cit. supra*, note 1, at 2891.)

Mr. Walker denied, however, that the language of the offering circular might have created a misapprehension in the minds of the investing public. He testified (*id.*, at 2905) :

Q. On the other hand, would you not be giving the stockholders a false hope when you refer to these companies as "these companies are of the so-called Standard Oil group" when the whole purpose was not to keep them in the Standard Oil group, but to put them in another group?

A. But the Standard Oil group still held just as many shares as this corporation held.

Q. But the Standard Oil group disposed of one-half of its holdings to you; isn't that so?

A. Let me say, when you say Standard Oil group, no. Mr. Rockefeller and his associated charities disposed of half of their holdings but the so-called Standard Oil group, which included the Harknesses, the Pratts, the Teagles, and all sorts of people, did not sell any of their stock in this trade.

Q. They did not sell any stock where?

A. In this trade \* \* \*.

<sup>147</sup> See *infra*, p. 273 and note 169.

<sup>148</sup> In May 1929 Blair & Co., Inc., was merged with Bancamerica Corporation, the investment affiliate of Bank of America National Association, to form Bancamerica-Blair Corporation, which in turn became the investment affiliate of the Bank of America N. A. By virtue of the fact that Transamerica Corporation controlled Bank of America N. A., Bancamerica-Blair Corp. became a subsidiary of Transamerica. In 1932 when the National City Bank of New York acquired Bank of America N. A., Bancamerica-Blair Corporation was excluded from the transfer, and it remained a subsidiary of Transamerica Corporation. Early in 1929, shortly after he became chairman of the board of Petroleum Corporation, Elisha Walker became chairman of the board of Bancamerica-Blair Corporation and of Transamerica Corporation and chairman of the Executive Committee of Bank of America N. A. These positions Mr. Walker retained until his much publicized split with the Giannini interests and the battle which ensued, terminating in February 1932 with the ousting of Walker from his executive position with these corporations. (See *The New York Times*, Feb. 16, 1932, p. 29.) Later in 1932 Mr. Walker became a partner in the banking house of Kuhn, Loeb & Co.



ance.<sup>149</sup> After the Petroleum Corporation had been operating for some period of time, most of this group of directors resigned, either voluntarily or were, as stated by Elisha Walker, "requested, if they didn't mind, to retire."<sup>150</sup> By 1932, after the consolidation of the Prairie companies with Sinclair Consolidated Oil Corporation, the number had been reduced to 14. This board of 14 directors included 8 of the original dominating group and, in addition, Earl W. Sinclair. By the end of 1935 the board was further reduced to 13 members, 9 of whom either were or formerly had been affiliated with Blair & Co., Inc. or the Sinclair interests.<sup>151</sup> Elisha Walker, who was president of Blair & Co., Inc., and its successor, Bancamerica-Blair Corporation, became the first chairman of the board of directors of Petroleum Corporation of America and retained the office of chairman continuously until December 1932. He remained a member of the board of directors thereafter, and at the end of 1938 was still listed by the Corporation as a director. John H. Markham, Jr. remained in office until February 1933 and was succeeded by Huntington D. Sheldon, who had started with the Corporation in January 1929 as assistant secretary. Mr. Sheldon is still the president of the Corporation.

<sup>149</sup> For the complete list, see Appendix C. Hunter Marston admitted that this was an unusually large board of directors. He testified (op. cit. supra, note 1, at 2872) :

\* \* \* It was unusual. I think it was predicated on the theory that they wanted to get sort of sources of influence throughout different geographical territories, so that the business of this company—if we had not run into the panic—might have been that of buying securities which would have gone into the consolidation. They attempted at that time—that was the theory promulgated—to get directors in Texas, California, Oklahoma, and so forth.

Q. Do you know of any other industrial corporation that had [forty-five] directors or any other investment trust?

A. I don't know of any, unless it is a bank.

The influence of these names in every section of the country is attested by the fact that the stockholders of the corporation represented every state in the union, as well as the District of Columbia, Alaska, and the Philippine Islands. (Reply to the Commission's questionnaire for Petroleum Corporation of America, Item 53.)

<sup>150</sup> Op. cit. supra, note 1, at 2937.

<sup>151</sup> In March 1933 J. Paul Getty was made a member of Petroleum Corporation's board of directors at his own request, after purchasing a substantial block of stock. (Id., at 2937.) A corporation controlled by Mr. Getty, named Getty, Inc., owned 200,000 shares of Consolidated Oil Corporation stock. Petroleum Corporation had in its portfolio 300,000 shares of Tidewater Associated stock. (This stock had evidently been accumulated by Petroleum Corporation in connection with the Mission Securities venture. See infra, note 264.) Apparently, as part of a transaction to eliminate Mr. Getty from the board of directors of Petroleum Corporation in 1933, Petroleum Corporation in a simultaneous transaction purchased from Getty, Inc., its 200,000 shares of Consolidated Oil Corporation stock at \$15 per share while it sold to Getty, Inc., its 300,000 shares of Tidewater Associated Oil stock at \$10 per share. (The transaction actually constituted a transfer of securities, as both items resulted in a total of \$3,000,000.) That Petroleum Corporation had no desire to acquire an additional block of Consolidated Oil at that time is evidenced by the fact that the Corporation then called in J. F. Feder, a private banker, and told him that Petroleum Corporation desired to dispose of a block of Consolidated Oil stock. Petroleum Corporation granted to Feder & Co. an option (without consideration) on 300,000 shares of its Consolidated Oil stock at prices ranging from \$12 to \$14.50 per share. Feder took up from the Corporation 150,000 shares of the Consolidated Oil stock at an average price of \$12.83. Petroleum Corporation, in turn, paid Getty, Inc., \$15.00 per share for its 200,000 shares of Consolidated, thus taking a loss of \$2.17 per share on 150,000 of the shares it had sold to Feder. These transactions completed, Mr. Getty, in April 1934, resigned from the board of Petroleum Corporation. Elisha Walker stated with respect to Getty's resignation, "I don't know whether it was part of any fixed understanding. It may have been discussed but I really don't know. I don't remember." (Id., at 2944.)

As has already been indicated, those who formed the Petroleum Corporation of America and who dominated it from its inception did not publicly disclose to the investing public that the primary function of the corporation was to serve as an agency for effecting the realignment of a section of the oil industry, a realignment in which Sinclair was to be the focal point and dominant figure.<sup>152</sup> Elisha Walker, who became chairman of the corporation's board of directors, testified:<sup>153</sup>

Q. Now, will you please tell us what persuaded the Purchase Group not to attempt a public distribution, but to sell it [the Prairie stocks] to the investment trust at a profit?

A. I think it was just following out the thought of waiting on consolidations and to keep this block of stock together so that it would be a basis for forming something substantially worthwhile in the oil industry.

Q. Now, of course, as an organizer of the investment trust the primary concerns were the considerations for the stockholders of the company?

A. Yes. Decidedly.

Q. I mean whether it was beneficial to the oil industry, beneficial to the Sinclair or the Prairie Companies; of course, that consideration should have played no part in connection with the sale or distribution of the Petroleum Corporation to the public; isn't that so?

A. You are right. But, of course, if it was good for the industry, it would have been good for the company.

Q. \* \* \* there came a time in between November 26 and January 16, 1929, when it was determined that the procedure was that it was going to be sold in one lot to an investment company to be formed; isn't that so?

A. Well, that is when the final decision was taken. As I say, the general thought had been months even in advance of that.

Q. And you say that the motivating cause was to keep the block intact so that a merger and consolidation could be effected and, by virtue of that consolidation, the oil industry would be benefited and, as a necessary corollary, the interest of the stockholders of the Petroleum Corporation of America would be served? Is that it?

A. Yes. In general.

Q. Now, that was a vital factor in connection with the acquisition of that block of stock by the Petroleum Corporation of America? Isn't that so?

A. I would say so.

Mr. Walker felt that it would have been "very unwise" to apprise the public, to which the stock was being marketed, of the true plans in the minds of the corporation's sponsors. Mr. Walker testified:<sup>154</sup>

Q. You determined to turn it over to the investment company and hold it intact, looking forward to the time when you could use it in a consolidation and for improving the oil business, and therefore the position of the Petroleum Corporation of America stockholders?

A. Yes.

Q. Now, this represented an investment of \$45,000,000 for the investment company, which was substantially half the total assets of the corporation

<sup>152</sup> See the testimony of Hunter Marston set forth *infra*, this section, to the effect that the consolidation plans were centered about Sinclair Consolidated: "It was an important factor from the very inception and was a basis for, we felt, a very complete development \* \* \*."

<sup>153</sup> *Op. cit. supra*, note 1, at 2898.

<sup>154</sup> *Id.*, at 2903.

after the bankers took nine and a half million dollars in commissions? Isn't that so?

A. Yes.

Q. And yet there was not the slightest intimation of this position, was there, Mr. Walker, that one of the \* \* \* reasons why the block was kept intact and sold to the investment company was that ultimately they hoped to go through a consolidation, whether with or without the consent of the Rockefellers?

A. I think it would have been very unwise to talk about a consolidation which might not eventuate, because you would be giving the public a false hope.

The formation of Petroleum Corporation of America created, in effect, a hundred-million-dollar pool of the public's funds to be employed without hindrance in the furtherance of the plan to bring under the domination of the Sinclair interests a large section of the oil industry. The public, which supplied the pool, however, was at no time apprised of this purpose. Hunter Marston, when interrogated on this subject, disputed the inference that the money of the stockholders of Petroleum Corporation was being used to help the Sinclair interests achieve their aims:<sup>155</sup>

Q. Mr. Marston, I think you told us that the negotiations for the merger between Prairie Pipe and Prairie Oil and the various other companies had started as far back as 1927? Isn't that so?

A. \* \* \* Yes; we had discussed it probably a year or two previously.

Q. And from the very inception was the Sinclair Consolidated Oil Company one of the companies that was to be part of the group?

A. My recollection is that it was. It was an important factor and was a basis for, we felt, a very complete development by its association with other companies.

Q. Well, isn't this whole transaction, Mr. Marston, susceptible of the inference, at least, that the public's money was being used to help the Sinclair interests effect a merger?

A. No; that would not be my interpretation of it.

Subsequently, however, Mr. Marston testified:<sup>156</sup>

Q. But the formation of Petroleum Corporation of America brought together a large fund, which was used to purchase a substantial part of Prairie Oil & Gas and Prairie Pipe Line; isn't that correct?

A. Yes, sir.

Q. And that was the lot turned in and exchanged in the merger subsequently effected.

A. Ultimately.

Q. So it is true that the public's money that was put in Petroleum Corporation of America was used to facilitate that consolidation?

A. You mean the ultimate consolidation?

Q. Yes.

A. That was not the primary purpose in the first instance. It resulted in the eventuality of that.

## 1. ADDITIONAL PURCHASES OF PRAIRIE STOCKS

By virtue of its original purchase of the Prairie stocks for \$46,600,000, Petroleum Corporation of America commenced its operations with

<sup>155</sup> Id., at 2844.

<sup>156</sup> Id., at 2856.

approximately 46% of its total assets concentrated in this one investment situation. Although the outlook for the Prairie companies was becoming increasingly unfavorable,<sup>157</sup> and despite this initial heavy concentration in the Prairie stocks, the management of Petroleum Corporation steadily added to them. By the end of 1929 the Corporation had purchased an additional 277,800 shares of Prairie Oil & Gas stock and an additional 40,600 shares of Prairie Pipe stock. Petroleum Corporation's investment in both these stocks then totaled \$64,456,525 and represented 67% of its total assets at that date.<sup>158</sup>

Of the 277,800 additional shares of Prairie Oil & Gas stock which Petroleum Corporation purchased in 1929, a block of 150,000 shares was acquired from Sinclair Consolidated Oil Corporation at \$60 per share at a time when the market price was \$55 per share.<sup>159</sup> Elisha Walker, who was chairman of the board of directors of Petroleum Corporation when the purchase was made, was unable to remember why a premium of \$750,000 was paid to Sinclair Consolidated.<sup>160</sup>

At the same time this purchase was made from Sinclair Consolidated at a price of \$750,000 above market, allegedly in order to obtain "that block of stock, that big block," the trading account which Blair & Co. had formed in Prairie Oil & Gas stock in January 1929<sup>161</sup> was still attempting unsuccessfully to dispose of the 50,000 shares of Prairie Oil & Gas stock it had accumulated and upon which it had a substantial unrealized loss. Although the syndicate agreement under which this account operated expired on June 1, 1929, it was extended to November 1929, and again to February 1930, at which date it was still long 39,400 shares at a heavy loss.<sup>162</sup> Blair & Co., Sinclair, and various directors of Petroleum Corporation of America, as members of the original Prairie Syndicate, were necessarily fully acquainted with the status of the trading account in which they were directly interested.

On the same day that Petroleum Corporation (of which Elisha Walker was the chairman of the board) bought the Prairie stock for \$9,000,000 from Sinclair Consolidated (of which Elisha Walker was

<sup>157</sup> This was due not only to the unfavorable condition of the oil industry plus the increasingly unfavorable general economic situation, but in the case of the Prairie companies, to new competitive factors whose advent began to be rumored about this time. See discussion of Ajax Pine Line, *infra*, pp. 280-1.

<sup>158</sup> Total assets at the end of 1929 were \$96,028,332. (Reply to the Commission's questionnaire for Petroleum Corporation of America, Exhibit 4.)

<sup>159</sup> *Op. cit. supra*, note 1, at 2950. The purchase was made on June 7, 1929.

<sup>160</sup> Elisha Walker testified (*Ibid.*):

Q. Do you know why that particular block of stock was purchased above the prevailing market at that time?

A. I can't remember why now. I presume the directors thought it was a good thing to have that block of stock, that big block. I suppose they were willing to pay a little above the market for it.

<sup>161</sup> See discussion of Prairie Oil & Gas trading accounts, *supra*, pp. 238-49.

<sup>162</sup> Ruloff Cutten confirmed in his testimony that this account was extended because of its inability to dispose of the stock which it was "long." He testified (*op. cit. supra*, note 1, at 3133):

Q. \* \* \* will you tell me why it was necessary to continue that account after the block had been sold by the purchase group?

A. Why this account?

Q. Yes.

A. The trading account?

Q. Yes.

A. Because they were long stock and they were long at a loss. They were hopeful of getting out even, I imagine. I believe it was extended either for six months or nine months. I have forgotten which.

a director),<sup>163</sup> Sinclair Consolidated, apparently with part of the money received from Petroleum Corporation, purchased from Bancamerica-Blair Corporation (of which Elisha Walker was president) 500,000 shares of Petroleum Corporation's stock at \$15 per share (represented by part-paid certificates subject to a \$14 call),<sup>164</sup> a transaction on which Blair & Co. realized a profit of approximately \$225,000.<sup>165</sup> The greater part of these 500,000 shares of stock had been acquired by Bancamerica-Blair Corporation a few days prior to its sale to Sinclair Consolidated Oil, from the stabilizing account managed by Bancamerica-Blair Corporation. This stabilizing account for which the Banking Group had assumed liability at the time of the public distribution of Petroleum Corporation's stock, had ended up long 629,095 shares of Petroleum Corporation's stock at a substantial loss.<sup>166</sup> Concerning this operation Mr. Walker testified:<sup>167</sup>

Q. We have the syndicate long 629,095 shares, and then a letter was sent out by Blair & Company (the manager of the account) saying they were willing to buy the stock from these people at \$14.50. They took up approximately 229,000, which left 400,000. That 400,000, in addition to the 88,000 by Blair & Company, and 12,000 they purchased in the open market, made 500,000 which was sold to the Sinclair Consolidated Oil Corporation at \$15, plus the \$14 call?

A. Yes. You mean that the syndicate sold back to Blair 400,000: is that it?

Q. That is right, at \$14.50, and Blair & Co. sold that to Sinclair Consolidated at \$15, so that Blair and Company made half a point, or on the 400,000 shares they made \$200,000.

A. Yes.

Q. Of course, the rest of the participants in that syndicate, to use a colloquial expression, took a licking, didn't they?

A. I don't know whether they did or not. I would be rather surprised if they had not made a profit. \* \* \*

Q. Do you know whether there was any disclosure to the other participants that Blair & Company had this arrangement to sell these 500,000 shares to Sinclair at a half a point profit?

A. I don't remember anything definite about the trade.<sup>168</sup>

The outcome of this series of transactions thus appears as follows: Petroleum Corporation of America by its purchase from Sinclair Consolidated Oil Corporation added 150,000 shares costing \$9,000,000 to its already substantial position in Prairie Oil & Gas paying a premium above market of \$750,000; Sinclair Consolidated Oil Corporation dis-

<sup>163</sup> Mr. Walker testified before the Senate Committee on Banking and Currency (op. cit. supra, note 132, Part 7, p. 3324) that in 1928 he was not only a member of the board of directors of Sinclair Consolidated Oil Corporation but also a member of the executive committee of the board of directors. Although Mr. Walker continued to be a director of Sinclair Consolidated in 1929, it is not entirely certain that he also continued to be a member of the executive committee thereof.

<sup>164</sup> Op. cit. supra, note 1, at 2948.

<sup>165</sup> The exact amount of Blair & Company's profit was \$224,587.28. (Derived from supplementary information supplied the Commission for Petroleum Corporation.)

<sup>166</sup> See discussion of this stabilizing account, supra.

<sup>167</sup> Op. cit. supra, note 1, at 3046.

<sup>168</sup> Earl W. Sinclair testified that he carried on negotiations for this transaction with Mr. Markham and Mr. Walker (id., at 3077). At that time Elisha Walker was also a director of Sinclair Consolidated Oil Corporation. E. R. Tinker, Arthur W. Cullen, and H. H. Rogers, other directors of Petroleum Corporation, were also at that time directors of Sinclair Consolidated. Subsequently, Mr. Markham and Hunter Marston were placed on the board of Sinclair Consolidated. (id., at 3078-9.)

posed of its holdings of Prairie Oil & Gas to Petroleum Corporation for \$9,000,000, and acquired from Bancamerica-Blair Corporation for \$7,500,000, 500,000 shares of Petroleum Corporation (subject to a call of \$14 per share), which made Sinclair Consolidated the largest single stockholder of Petroleum Corporation;<sup>169</sup> Bancamerica-Blair Corporation realized a net profit of approximately \$225,000 on its sale of the Petroleum stock to Sinclair Consolidated, while Bancamerica-Blair Corporation's associates in the Petroleum Corporation stabilizing account suffered a substantial loss.<sup>170</sup>

Of more far-reaching significance is the fact that this transaction marked the start of an intrenched system of circular ownership between Petroleum Corporation (which owned at that time 15,000 shares of Sinclair Consolidated Oil stock)<sup>171</sup> and Sinclair Consolidated Oil Corporation (which now owned 500,000 shares, 17% of the total outstanding shares, of Petroleum Corporation's stock).<sup>172</sup>

Following the purchase of the block of Prairie Oil & Gas from Sinclair Consolidated in June 1929 Petroleum Corporation continued steadily to increase its holdings of both Prairie Oil & Gas and Prairie Pipe stock. These additional purchases were made both in the open market and privately. On October 17, 1929, on the eve of the market break, 100,000 shares of Prairie Oil & Gas were purchased through Bancamerica-Blair Corporation and the Bankers Trust Company from Edward H. Harkness at \$50 per share for an aggregate of \$5,000,000.<sup>173</sup> At the same time active purchasing in both Prairie stocks was being carried on almost daily by the Corporation in the

<sup>169</sup> At the end of 1929 there were outstanding 2,937,900 shares of Petroleum Corporation's stock. (Reply to the Commission's questionnaire for Petroleum Corporation of America, Item 280.) The 500,000 shares purchased by Sinclair Consolidated therefore represented in excess of 17% of the total shares outstanding. Apparently no other stockholder ever owned more than 44,000 shares of Consolidated Oil stock. (Op. cit. supra, note 1, Commission's Exhibit No. 334.) Thus, instead of owning merely 150,000 shares of Prairie Oil & Gas, Sinclair Consolidated acquired working control of Petroleum Corporation with \$100,000,000 of assets, among which were more than 450,000 shares of Prairie Oil & Gas (including the 150,000 taken over from Sinclair) and more than 550,000 shares of Prairie Pipe. Obviously, Sinclair's influence in promoting a consolidation with the Prairie companies was thereby increased manifold.

<sup>170</sup> The exact amount of the loss suffered by the Banking Group was not definitely ascertained. However, the entire amount of commission earned by this group, the sum of \$3,088,281 was first credited against the cost of the 629,095 shares the account was long, which Bancamerica-Blair Corporation stated in its letter of June 3, 1929 (referred to in the testimony quoted supra) reduced the cost of this stock to \$15.44 per share (subject to a \$14 call). Bancamerica-Blair offered to distribute the stock to the members of the participants at cost (\$15.44 per share) or to purchase all or any part of said shares at \$14.50 per share. Apparently 400,000 shares were sold to Bancamerica-Blair Corporation on this basis, which meant a further loss to the other members of 94 cents per share, or \$376,000. This sum, added to the commission which was earned by the members of the Banking Group but never paid to them, would indicate a loss of approximately \$3,500,000.

<sup>171</sup> For details of Petroleum Corporation's acquisition of this block of Sinclair Consolidated Oil stock, see *infra*.

<sup>172</sup> As has been pointed out supra, the Sinclair interests did not find it necessary, following their acquisition of working control of Petroleum Corporation, to effect any change in the composition of the board of directors of Petroleum Corporation or in the executive personnel.

<sup>173</sup> Edward H. Harkness was one of those named by Elisha Walker (see supra) as among the Standard Oil group which retained its Prairie holdings. According to information received from the Bankers Trust Company, Mr. Harkness did not know at the time the identity of the buyer of his block of stock. (Derived from supplementary information supplied the Commission for Petroleum Corporation of America.)

open market.<sup>174</sup> As of December 31, 1929, Petroleum Corporation had \$64,356,595 or 67% of its then total assets invested in the stock of the two Prairie Companies.<sup>175</sup> Questioned concerning the magnitude of Petroleum Corporation's investment in the Prairie stocks Elisha Walker stated,<sup>176</sup> "Nobody ever dreamed of it."

Subsequent to the market break of 1929, the stock market price of both Prairie stocks began to decline rapidly. On January 25, 1930, Petroleum Corporation established formal trading accounts in both Prairie stocks. Throughout 1930, and until April 1931, these accounts traded in the Prairie stocks almost daily.<sup>177</sup>

The continued investments by Petroleum Corporation in the Prairie stocks seem attributable only to the refusal of Sinclair and his associates to abandon their determination to effect a merger between the Prairie Companies and Sinclair Consolidated. Petroleum Corporation under their domination was obviously one of the principal instrumentalities by which this result was to be achieved. Hunter Marston when examined on this subject testified:<sup>178</sup>

Q. You say the discussions continued with respect to the merger, Mr. Marston, past the time that the Trust, or the Petroleum Corporation of America, acquired this \$45,000,000 worth of Prairie Pipe and Prairie Oil and Gas?

A. Yes.

Q. The fact of the matter is, is it not, Mr. Marston, that the Petroleum Corporation of America continued buying Prairie Pipe Line and Prairie Oil and Gas, even after they purchased that \$45,000,000 worth in the first instance?

A. I believe that is correct.

\* \* \* \* \*

Q. Now isn't that indicative of the fact that the trust was accumulating this stock in order to be in a position to effect a merger?

A. Well, they felt, naturally they must have felt, that the purchase of this stock was an advantageous one and if a merger were effected, they expected to make a profit.

Q. Well, the fact of the matter is——

A. (Interposing.) But the great disaster happened on or about that time the panic started.

Q. Well, as of December 31, 1929, they still continued purchasing Prairie Oil and Gas Company common and Prairie Pipe Line Company common. \* \* \* now, there evidently was some difficulty in effecting the contemplated merger? Isn't that so, Mr. Marston? When was the merger ultimately effected?

A. Are you referring to the larger merger or to the merger between the Sinclair Company?

<sup>174</sup> Op. cit. supra, note 1, Commission's Exhibit No. 352.

<sup>175</sup> Reply to the Commission's questionnaire for Petroleum Corporation of America, Table 2.

<sup>176</sup> Op. cit. supra, note 1, at 2946. Mr. Walker testified (ibid) :

Q. These offering circulars, Mr. Walker, to the stockholders, of course, gave no indication that eventually the Trust would own \$64,000,000 of that stock?

A. Nobody ever dreamed of it.

Q. Well, of course, when you say that nobody dreamed of it, you would think this was something that happened without any volition on the part of the board of directors of the Petroleum Corporation of America. I mean, this wasn't an act of God. This was a deliberate, intentional act of the board of directors of the Petroleum Corporation of America in acquiring \$64,000,000. Isn't that so?

A. Well, it was an act in connection with the exchange of Prairie Oil & Gas and Prairie Pipe Line, yes, for Consolidated stock, yes, if that is what you mean.

<sup>177</sup> Id., Commission's Exhibit No. 352.

<sup>178</sup> Id., at 2846-9.



Q. The larger merger never took place?

A. No; the larger merger never evolved.

Q. But the merger with the Sinclair Consolidated Oil Company and the Sinclair Oil—

A. It did eventuate.

Q. That was in March 1932? Isn't that so?

A. I don't recall. You probably have the date there.

Q. And yet Petroleum Corporation of America never got out of its position in Prairie Pipe Line and Prairie Oil and Gas?

A. No; they did not, except through exchange of stock, ultimately.

Q. And ultimately they exchanged it for—Consolidated Oil stock, and yet the chart indicates, and you know it is a fact, that the price of that stock was declining and declining and declining?

A. It was.

Q. It seemed to have no bottom? Isn't that so, Mr. Marston?

A. Well, that chart indicates there was quite a decline.

Q. And yet no attempt was made by the Petroleum Corporation of America to diminish its position in that stock?

A. Well, they felt they had something with inherent value, and they had purchased the stock with the idea that an ultimate consolidation would evolve, and to have disposed of the stock—and I am just speaking from my own impression—it would have meant either putting the money in something else, which apparently the Board didn't feel was safe, or as safe as being in the Pipe Line.

Q. Of course, there was the other side of this picture \* \* \*. Had the trust determined to lessen its position in that stock, that would have meant a dissipation of this substantial block, which was an effective block as far as the merger proceedings were concerned. Isn't that so?

A. Yes; usually 10 per cent is an effective block.

## 2. PETROLEUM CORPORATION PURCHASES STOCK OF SINCLAIR CONSOLIDATED OIL CORPORATION

On April 13, 1929, Petroleum Corporation purchased 15,000 shares of Sinclair Consolidated Oil stock at \$40 per share from the trading account operated by the Sinclair Consolidated Oil Syndicate.<sup>179</sup> The market price of the Sinclair stock at that time ranged from \$37 to \$39½ per share. The Sinclair Syndicate closed operations three days after this transaction was effected.<sup>180</sup> Elisha Walker, chairman of the board of directors of Petroleum Corporation, and president of Blair and Co., Inc., which was active in the Sinclair Consolidated Syndicate,<sup>181</sup> denied that the funds of Petroleum Corporation were being used "to bail" the Sinclair Syndicate out of its closing long position. Mr. Walker suggested that it might be good business "to buy up the tail end of a pool." He testified:<sup>182</sup>

Q. Petroleum Corporation wasn't bailing this trading account out of its long position at the end?

A. I should imagine just the reverse, probably Petroleum Corporation was aware that the Syndicate had been closed out of all its holdings, and probably

<sup>179</sup> Id., at 3027-9. For discussion of this syndicate, see *supra*.

<sup>180</sup> Ibid.

<sup>181</sup> The participants in the Sinclair Consolidated Syndicate, as has been pointed out *supra*, were almost identical with those in the Prairie Syndicate. This was conceded by Elisha Walker. (Id., at 3027.)

<sup>182</sup> Id., at 3028.



thought that it would be a very good time, with the closing out of that account and the ceasing of the liquidation to make what for it was a more or less modest purchase of 15,000 shares.

Q. \$600,000. I do not understand, frankly, how termination of the syndicate account made that a more attractive purchase. The fact of the matter is that as soon as the pool stopped trading and stepped out of the market, the natural reaction would be a decline.

A. I do not agree necessarily on that. I think when the syndicate is closed and there is no more stock being put on the market from the syndicate, the market would take care of itself and might do better rather than worse.

Q. Is it your experience that when a pool stops operating that there is an increase in price to the stock?

A. I know of cases where people have thought it good business to buy up the tail end of a pool.

The Sinclair Consolidated Oil Corporation stock never thereafter rose above  $40\frac{7}{8}$  at its highest point, and even before the market break of October it was selling below 35. Subsequently, it declined steadily to an eventual low of  $4\frac{1}{8}$ .<sup>183</sup> While defending energetically the good faith of all parties concerned in the purchase of the Sinclair stock, Elisha Walker admitted that the transaction was tinged with self-dealing on the part of the inside group—those who comprised both the Prairie and the Sinclair Syndicates and who were then in control of Petroleum Corporation. Mr. Walter testified:<sup>184</sup>

Q. The fact is, though, that Blair & Company was interested in this pool of Sinclair Consolidated Oil Corporation.

A. Yes.

Q. And Harry F. Sinclair was interested?

A. Yes \* \* \*.

Q. And the fact is that you were a participant in Sinclair Consolidated Oil pool?

A. Yes.

Q. And the fact is that you were one of the moving spirits in Petroleum Corporation.

A. Petroleum Corporation had a paid president, and a very capable and able man, Mr. John Markham \* \* \*.

Q. And the fact is that, without imputing any bad faith, that you were substantially on both sides of that transaction; isn't that so?

A. I was substantially on both sides; yes.

From October 21, 1929, to November 14, 1929, Petroleum Corporation continued purchasing Sinclair Consolidated Oil stock in a collapsing market. These purchases, evidently designed to cushion the fall in Sinclair Consolidated stock during the market break, were made on a scale down from  $\$33\frac{5}{8}$  per share to \$21 per share in blocks ranging in size from 5,000 shares to 300 shares. A total of 50,000 shares additional was bought during this period for the aggregate sum of \$1,373,777.<sup>185</sup> In February 1930, Petroleum Corporation established a trading account in the stock of Sinclair Consolidated Oil Corporation which conducted trading operations in this stock almost throughout the entire year of 1930.<sup>186</sup>

<sup>183</sup> Id., Commission's Exhibit No. 342.

<sup>184</sup> Id., at 3030.

<sup>185</sup> Id., Commission's Exhibit No. 352.

<sup>186</sup> Ibid.

### 3. PURCHASE OF VACUUM OIL COMPANY STOCK FROM SINCLAIR CONSOLIDATED

On October 5, 1929, shortly before the market break, Petroleum Corporation of America purchased from Sinclair Consolidated Oil Corporation 35,000 shares of stock of Vacuum Oil Company.<sup>187</sup> In this transaction Earl W. Sinclair represented Sinclair Consolidated Oil Company and Elisha Walker represented Petroleum Corporation. Mr. Walker was at that time both chairman of the board of Petroleum Corporation and a director of Sinclair Consolidated Oil Corporation.<sup>188</sup>

The Vacuum Oil Company stock had cost Sinclair Consolidated Oil Corporation approximately \$75 per share. Petroleum Corporation purchased it from Sinclair Consolidated at \$120 per share, the approximate market price at that time, for a total of \$4,199,000. Earl W. Sinclair testified that “\* \* \* the price got to a point where we thought it was wise to sell and get the money, or at least dispose of it at that price.”<sup>189</sup> Subsequent events vindicated the judgment of the directors of Sinclair Consolidated Oil Corporation. Within two months after the purchase, Petroleum Corporation had an unrealized loss on this block of Vacuum Oil Company stock of \$1,000,000, and, at the end of 1930, its unrealized loss was \$2,300,000.<sup>190</sup> At the end of 1935, stock of the merged company, Socony-Vacuum Corporation, had been received by Petroleum Corporation for these shares, the cost of the block had been increased to \$6,128,000 by additional purchases and the unrealized depreciation had mounted to \$3,600,000. At that date, this block of Socony-Vacuum stock was the second largest holding of the Corporation.<sup>191</sup>

This transaction provides an apt demonstration of the anomalous situations created when an officer of an investment company sits on the board of directors of a company whose interests in a transaction are adverse to those of the investment company. The directorate of Sinclair Consolidated Oil Corporation of which Elisha Walker was a member “thought it was wise to sell and get the money, or at least dispose of it (Vacuum Oil stock) at that price.”<sup>192</sup> Elisha Walker as chairman of Petroleum Corporation’s board of directors evidently thought it was wise to buy it (Vacuum Oil stock) at that price and to pay over to Sinclair Consolidated Oil Corporation “that money” which totaled \$4,199,000.

### 4. REPURCHASES OF OWN STOCK BY PETROLEUM CORPORATION

Within a few months after they were first issued, the shares of Petroleum Corporation were selling on the market at a discount of several points.<sup>193</sup> In July 1929, the board of directors authorized re-

<sup>187</sup> *Id.*, at 3038, 3080. See also *supra*, note 163.

<sup>188</sup> *Op. cit. supra*, note 1, at 3080.

<sup>189</sup> *Id.*, at 3081.

<sup>190</sup> Reply to the Commission’s questionnaire for Petroleum Corporation of America, Table 2.

<sup>191</sup> *Ibid.*

<sup>192</sup> *Op. cit. supra*, note 1, at 3081 (testimony of Earl W. Sinclair).

<sup>193</sup> During May 1929 the market price of Petroleum Corporation ranged between 30½ and 27½; during June, between 28 and 26½.

purchase of 500,000 shares of the Corporation's stock and gave authorization to the chairman to borrow up to \$15,000,000 for this purpose. As of December 31, 1929, the Corporation had repurchased 312,100 shares of the stock at a total cost of \$7,478,547.50.<sup>194</sup> This represented a repurchase of almost 10% of the total number of shares originally issued eleven months earlier. During the succeeding years repurchases were continued in a declining market. As of December 31, 1935, aggregate repurchases equaled 1,239,840 shares (almost 40% of the original issue) at a cost of \$14,469,322. The average price per share paid by Petroleum Corporation in its repurchases was \$11.67, as compared with the price of \$34 per share paid by the public in January 1929.<sup>195</sup>

These figures provide some indication of the severity of the decline in the market price of Petroleum Corporation's shares. In point of fact, the stock at the end of 1931 sank to a low of \$27 $\frac{7}{8}$  per share on the market.<sup>196</sup>

This attrition in the market price of Petroleum Corporation's shares was due not only to general market and economic conditions, but it reflected the extraordinary collapse which occurred in the market price of the shares of Prairie Oil & Gas and Prairie Pipe Line in which Petroleum Corporation's assets were so heavily concentrated. Prairie Pipe Line shares for which Petroleum Corporation had paid the Blair & Co. syndicate \$52 per share (calculated on the split-up basis), declined to a low of \$57 $\frac{7}{8}$  at the end of 1931; while Prairie Oil & Gas shares, for which Petroleum Corporation had originally paid \$60 per share, sank to a low of \$41 $\frac{1}{8}$ .<sup>197</sup>

This decline in the Prairie stocks which had been considered high-grade investment shares, was more severe even than the decline in Sinclair Consolidated Oil stock which never fell below \$41 $\frac{1}{8}$  from a high of \$407 $\frac{1}{8}$ .<sup>198</sup>

Reflecting the collapse in the market value of the Prairie stocks, the total assets of Petroleum Corporation had shrunk from more than

<sup>194</sup> Reply to the Commission's questionnaire for Petroleum Corporation of America, Item 54.

<sup>195</sup> The following table demonstrates the repurchase by the corporation of its own shares each year, 1929-1935, inclusive, with cost and asset value of the shares:

Year	Number of shares repurchased	Cost	Average price	Net asset value at year ends	Market price range during year	
					High	Low
1929	312,100	\$7,478,500	\$23.96	\$31.75	\$34 $\frac{1}{2}$	\$17
1930	202,300	2,173,500	10.74	13.82	29	5 $\frac{3}{4}$
1931	389,140	2,278,900	5.86	6.52	107 $\frac{7}{8}$	27 $\frac{7}{8}$
1932	160,400	916,600	5.71	7.23	7 $\frac{3}{8}$	2 $\frac{3}{8}$
1933	45,800	344,200	7.52	14.14	15	4 $\frac{9}{8}$
1934	52,800	514,100	9.74	12.56	14 $\frac{1}{4}$	8 $\frac{1}{4}$
1935	77,300	763,500	9.88	17.12	14	7 $\frac{5}{8}$
	1,239,840	14,469,300	11.67	* 14.73	-----	-----

\* Average.

<sup>196</sup> Op. cit. supra, note 1. Commission's Exhibit No. 346.

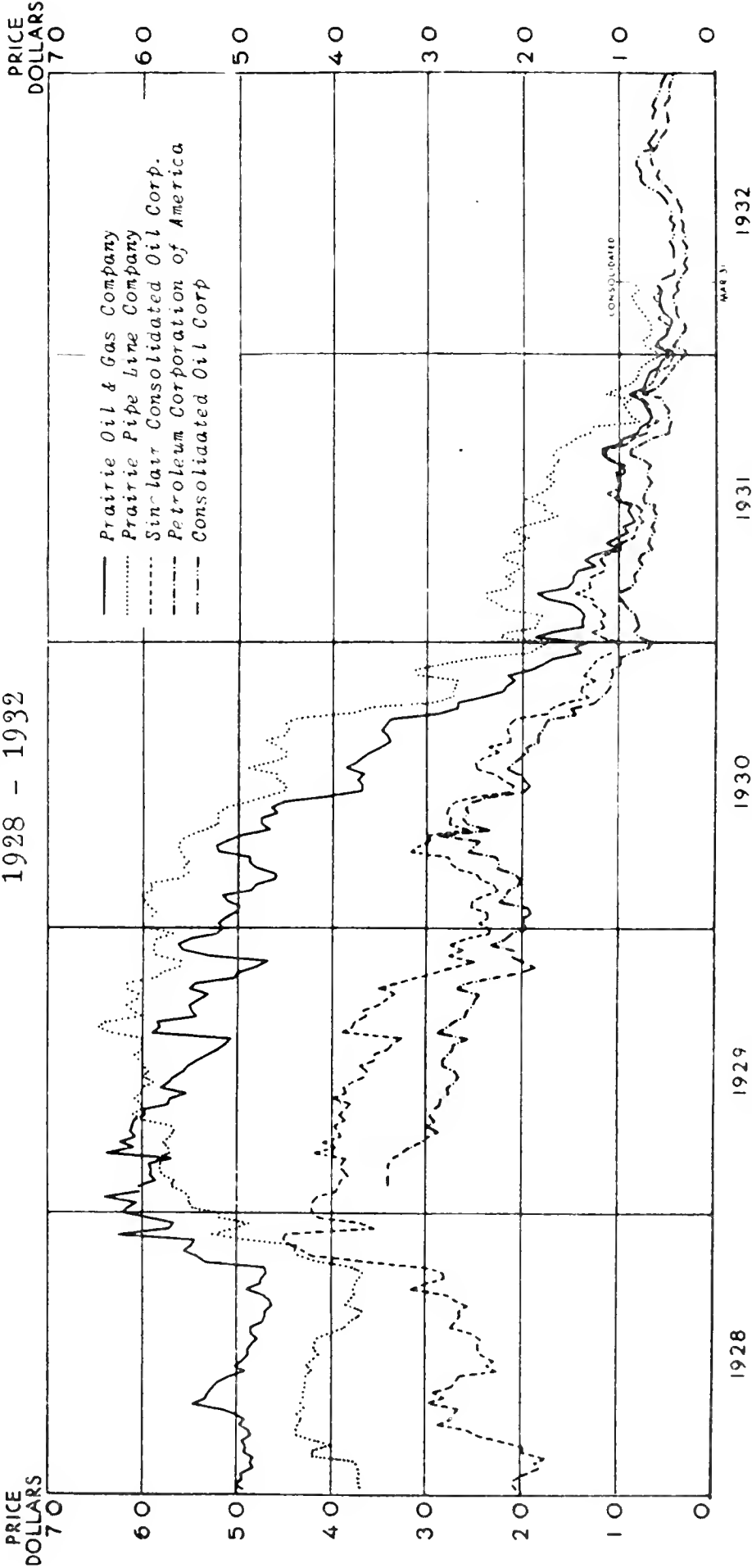
<sup>197</sup> Id., Commission's Exhibits Nos. 343 and 344.

<sup>198</sup> Id., Commission's Exhibit No. 342.

CHART 4

MARKET PRICES OF THE COMMON STOCKS OF PETROLEUM CORPORATION OF AMERICA,  
AND CONSOLIDATED OIL CORPORATION AND ITS PREDECESSOR COMPANIES

1928 - 1932



SOURCE: Public Examination, Petroleum Corporation of America, Commission's Exhibit No. 325.

\$100,000,000 at the inception to approximately \$15,000,000 at the end of 1931.<sup>199</sup>

The market action of these shares is graphically portrayed in Chart 4.

### 5. THE AJAX PIPE LINE

The unusual severity in the decline of the Prairie stock was attributed by witnesses at the examination before this Commission<sup>200</sup> and at the hearings before the Senate Committee on Banking and Currency,<sup>201</sup> to the construction by rival interests of a new pipe line which cut sharply into the business of the Prairie companies. This pipe line, named the Ajax Pipe Line, made it possible for various competing oil companies to capture business in the East, which until that time had belonged to The Prairie Oil & Gas Company. With the loss of its markets in the East, The Prairie Oil & Gas Company was forced to curtail its shipments through the lines of The Prairie Pipe Line Company.<sup>202</sup> Thus both companies suffered a blow of a permanent nature, superimposed on general depressed economic conditions.

It was alleged that among those responsible for the construction of the Ajax Pipe Line were several of the Standard Oil companies. W. S. Fitzpatrick named the Standard Oil Company of New Jersey, Standard Oil Company of Ohio and the Pure Oil Company as the participants in the Ajax Pipe Line venture.<sup>203</sup> Earl W. Sinclair stated that several of the Standard Oil interests constructed the Ajax Pipe Line. He testified with respect to the Ajax Pipe Line venture as follows:<sup>204</sup>

You will understand that during that period there was a great transformation in the value of the Prairie Oil and Gas Company, and the Prairie Pipe Line Company. The Prairie Oil and Gas had customers in the East and they used the Prairie Pipe Line. During this period the Prairie Oil and Gas Company lost its customers in the East, and the pipe line consequently lost their business. That was brought about by the building of a new line, the Ajax line.

Q. That Ajax Line was constructed by what interests?

A. Several of the Standard interests.

Q. So after the Standard Oil interests had sold out \$38,000,000 of the stock of the Prairie Oil and Gas and Prairie Pipe Line which ultimately was bought by the Petroleum Corporation, they then created by the new pipe line new

<sup>199</sup> The following table shows the total assets of Petroleum Corporation at year-ends from 1929 to 1935 (reply to the Commission's questionnaire for Petroleum Corporation of America) :

Dec. 31 :	Total assets (at market)
1929-----	\$93, 502, 000
1930-----	38, 845, 000
1931-----	15, 320, 000
1932-----	15, 833, 000
1933-----	30, 276, 000
1934-----	26, 215, 000
1935-----	34, 414, 000

For 1938 figures, see note 323, *infra*.

<sup>200</sup> Op. cit. *supra*, note 1, at 3090-1.

<sup>201</sup> Op. cit. *supra*, note 31, Part 7, pp. 3360-2.

<sup>202</sup> *Ibid*.

<sup>203</sup> *Ibid*.

<sup>204</sup> Op. cit. *supra*, note 1, at 3090.

competition with the Prairie Pipe Line, which ultimately caused a decline in the price of Prairie Pipe Line and Prairie Oil and Gas?

A. I say the Standard units brought that. Whether Rockefeller had anything to do with that, I don't know.

Q. You say Prairie Oil and Gas Line lost its customers in the East?

A. Yes.

Q. By what source were new competitive factors introduced?

A. By a new source of supply. I won't say they lost all their customers but as I remember they lost the larger percentage because the Pipe Line when it was consolidated was carrying very little oil for the Prairie Oil and Gas.<sup>205</sup>

## 6. ULTIMATE CONSOLIDATION OF THE PRAIRIE COMPANIES AND SINCLAIR CONSOLIDATED OIL CORPORATION

Despite the declining market prices and asset values of the stocks of all the companies concerned,<sup>206</sup> and highly unfavorable business conditions, negotiations for a consolidation of the various companies with Sinclair Consolidated Oil Corporation were pursued throughout 1930 and 1931.<sup>207</sup> Some of these negotiations, as in the case of Tidewater Associated Oil Company, proved fruitless.<sup>208</sup> But on March 31, 1932, a consolidation was actually effected with the Prairie companies.

By this time, Petroleum Corporation's holdings constituted about 24% of the entire outstanding stock issue of The Prairie Oil & Gas Company, 14% of the stock of The Prairie Pipe Line Company, and 2% of the stock of Sinclair Consolidated Oil Corporation.<sup>209</sup> At the same time Sinclair Consolidated Oil Corporation's holdings in Petroleum Corporation had increased to 23% of the total number of shares outstanding, largely as a result of Petroleum Corporation's repurchases of its own stock and the consequent reduction in the total outstanding.<sup>210</sup>

Moreover, the Bancamerica-Blair Sinclair group had succeeded in placing three of its members on the board of directors of each of the Prairie companies. Appendix E is a table indicating the interlocking directorates of Bancamerica-Blair, Petroleum Corporation, Sinclair Consolidated Oil Corporation, and the two Prairie companies throughout that period.

<sup>205</sup> The extent of the impairment actually suffered by the Prairie Companies as a result of the competition of the Ajax line was not established before this Commission. It is to be noted that the testimony of Earl W. Sinclair, quoted above, was offered by Mr. Sinclair in defense of the ratio of exchange allowed to the stockholders of the Prairie companies in the consolidation which was ultimately effected between those companies and Sinclair Consolidated Oil Corporation, discussed *infra*.

<sup>206</sup> See Chart 4, *supra*.

<sup>207</sup> *Op. cit. supra*, note 31, Part 7 (testimony of William S. Fitzpatrick).

<sup>208</sup> For details of the attempt to acquire control of the Tidewater Associated Oil Company, see *infra*, under the heading "Mission Securities Venture." Barnsdall Oil Company, which had originally been contemplated (see testimony of Hunter Marston, *supra*) could not be obtained although attempts were made. (Public Examination, The Equity Corporation, at 453.) However, acquisition of Rio Grande Oil Company was finally effected (see *infra*).

<sup>209</sup> At that time Petroleum Corporation had approximately \$33,000,000 invested in the stock of Prairie Oil & Gas; \$29,000,000 in the shares of Prairie Pipe; and \$2,500,000 in the shares of Sinclair Consolidated. (Reply to the Commission's questionnaire for Petroleum Corporation of America, Table 2.)

<sup>210</sup> See table of repurchases, note 195, *supra*.

By means of these intertwined relations the Sinclair-Blair group was able not only to throw the full weight of Petroleum Corporation's large stock holdings in the Prairie companies in favor of the consolidation, but the group had the assured support of persons whom they had placed on the board of directors of the Prairie companies.

In addition, the group could count on the active support of the management of the Prairie companies whose good will had been nurtured by various acts of thoughtfulness on the part of Sinclair and his associates. For example, not only was W. S. Fitzpatrick, president of Prairie Oil & Gas, gratuitously "cut in" on the profits of the Sinclair and Prairie Syndicates in the manner which has been related,<sup>211</sup> but in addition Fitzpatrick and other of the officers of the Prairie Oil & Gas had been induced in 1929 to exchange their Prairie stock for that of Sinclair Consolidated Oil Corporation on a basis favorable to them. Mr. Fitzpatrick, who was at the time president of The Prairie Oil & Gas Company, testified before the Committee on Banking & Currency of the United States Senate (73rd Congress) on this subject as follows:<sup>212</sup>

Q. Did you at that time (1929) in your transactions part with all your holdings of the Prairie Oil?

A. No.

Q. A substantial part of them?

A. A substantial part of them; yes.

Q. And you exchanged them for shares of the common stock of the Sinclair Company?

A. Yes.

Q. Which then was more or less a competing company?

A. Well, in a measure. But the general discussion that was going on indicated that the Sinclair contemplated a dividend of \$3 per share. I knew that was all the Prairie Oil could pay, if they could pay that much. I knew that I would receive, pending the further negotiations for the consolidation, dividend on 5 shares at \$3 a share instead of on 3 shares of Prairie at \$3 a share. I wanted those additional dividends. I got them. And I paid my income tax on that additional income.

Q. Did Mr. Rockefeller know that you exchanged the stock in a corporation in which he had a big interest for stock in a competing company?

A. I am quite sure Mr. Rockefeller did not know.

Q. Did Mr. Cutler know it?

A. I am quite sure that Mr. Cutler did not know it. I did not tell either one of them. It never occurred to me that it was any of their business.

Q. Did you tell any of the directors of the Prairie Oil & Gas Company?

A. Oh, yes. I told directors of the Prairie Oil & Gas Company, and several of the boys in both companies made the same exchange at the same time and in the same way.

\* \* \* \* \*

Q. At the time you effected the exchange of the holdings of Prairie for shares of the Sinclair Company on the basis of 5 shares of Sinclair stock for 3 shares of Prairie Oil stock, negotiations had already been in progress looking to a general consolidation of the two companies, had it not?

A. They were in the preliminary stages.

<sup>211</sup> See *supra*, pp. 265-6.

<sup>212</sup> *Op. cit. supra*, note 31, Part 7, pp. 3360-2.

Q. Yes. Now, at any time in those preliminary stages or particularly at the time when you effected exchange of your shares of Prairie Oil on the basis of 5 to 3 for shares of Sinclair Oil, did the Sinclair people indicate that they would be willing to make the same kind of exchange with the other stockholders of the Prairie Oil?

A. Yes. With the other officers.

Q. Oh. Only with the officers and not with the general body of the stockholders?

A. No; and that was limited to 20,000 shares.

Q. And that offer was held out only to the officers of the Prairie Oil & Gas Company?

A. Yes, sir.

Q. Did other officers besides yourself avail themselves of the offer?

A. Yes; they did.

Q. All of them?

A. Not all of them.

Q. Which of them did so?

A. Mr. Moody, Mr. Kelsey, and I think Mr. Wilhelm. I am not sure whether Mr. Wilhelm did or not, but there were several that did.

Q. Was the fact of such exchanges made known by you or any other officers of the Prairie Oil and Gas Company to the stockholders at the time that the negotiations were finally concluded on a share-for-share basis?

A. We didn't send out any letter to the stockholders; no.

Q. Well, did you indicate the fact to the stockholders of the company in any form?

A. There was no effort on anybody's part, so far as I know, to conceal it.

Q. But was the information given to the stockholders?

A. I don't know.

Q. Was there anything affirmatively done, in other words?

A. I don't know.

Q. I mean to inform stockholders of the deal that the officers had obtained for themselves?

A. I don't know.

Q. What was that answer?

A. I don't know.

Q. Doesn't it appear to you, Mr. Fitzpatrick, that while doing this you were really scuttling your ship with the Prairie Oil & Gas Company?

A. It did not.

Q. It would seem to me that if I owned 15% of a company and my officers were exchanging their stock for stock of a competing company I would consider that my ship was being scuttled.

A. It was not being scuttled. No; it was not being scuttled, and I am sorry that you gentlemen want to try a lawsuit that is pending out in Kansas, but if you do we will just have to try it here.

Q. I did not know there was a lawsuit pending out there.

A. Well there is a lawsuit pending in Kansas.

Q. About what?

A. A very few stock owners, something like 1% or 1½% of the stockholders are complaining that they did not get as much as they should have gotten in this deal.

Mr. Fitzpatrick stated further:<sup>213</sup>

I was at all times favorable to the consolidation \* \* \*.

<sup>213</sup> Id., at 3314.



The plan of consolidation which was adopted provided that each share of Prairie Pipe Line stock would be exchanged for  $1\frac{4}{10}$  shares of Sinclair Consolidated Oil stock, and each share of Prairie Oil & Gas stock would be exchanged for one share of Sinclair Consolidated stock.<sup>214</sup> The name of the corporation was then changed to Consolidated Oil Corporation.<sup>215</sup>

Harry F. Sinclair became chairman of the Executive Committee of Sinclair Consolidated Oil Corporation. Earl W. Sinclair became chairman of its Financial Committee and executive vice president. William S. Fitzpatrick became vice chairman of the Executive Committee.

Bertram Cutler, representing the Rockefeller interests, who, at the time of the sale of the Prairie stocks to the Blair group had admonished against a consolidation restricted only to Sinclair Consolidated Oil Corporation and the Prairie companies, now withdrew his interdiction.<sup>216</sup> On the other hand some of Prairie's smaller stockholders did not regard the consolidation plan as acceptable to

<sup>214</sup> As compared with the exchange ratio of 5 shares of Sinclair Consolidated for each 3 shares of Prairie Oil & Gas stock received by Fitzpatrick and his associates in 1929.

<sup>215</sup> The stockholders of the 3 companies were furnished with information which was outdated and inadequate. Although the plan of consolidation was submitted to the stockholders of the respective companies on January 14, 1932, and stockholders' ratification meetings were held March 1, 1932, the comparative balance sheets which were sent to the stockholders were based on the financial conditions of the companies as of May 31, 1931, a period some 10 months earlier. (Op. cit. supra, note 1, Commission's Exhibits Nos. 341-A, B, and C.) No comparative earnings' statements of any kind were submitted to the stockholders. According to Moody's (*Moody's Manual of Industrials*, 1932, p. 2853) Sinclair Consolidated Oil Corporation for the 13-month period ending January 31, 1932, showed a loss before dividends on its common stock (but after dividends on its preferred and interest on its bonds) of \$23,353,313. The Prairie Pipe Line Company for the 11-month period ending November 30, 1931, showed a loss before dividends on its common stock of \$547,341 (id., p. 2857); Prairie Oil & Gas Company for the 12-month period ending December 31, 1930 (the latest report published) showed a profit before dividends of \$1,496,183. (Id., p. 2856.)

On the basis of the comparative balance sheets sent to the stockholders, Sinclair Consolidated Oil Corporation had a net worth per share of common stock of \$33.76; Prairie Oil & Gas, \$35.91; Prairie Pipe Line Company, \$32.26. However, net current assets\* for the respective companies were: Sinclair Consolidated, \$6.55 per share; Prairie Oil & Gas Company, \$5.67 per share; Prairie Pipe Line Company, \$13.69 per share. But, whereas, the claims of the common stock of Sinclair Consolidated Oil Corporation were preceded by approximately \$82,000,000 of fixed debts and preferred stock, on the other hand the claims of the common stock of the two Prairie companies were entirely free and unencumbered.

The market value on March 1, 1932 (the date of the stockholders' ratification meetings) of the Sinclair Consolidated stock received by the stockholders of the Prairie companies through the exchange, equaled \$6.13 for each share of Prairie Oil & Gas stock and \$8.58 for each share of Prairie Pipe Line stock. In the case of Prairie Pipe Line stock the current asset value alone equaled, as has been indicated, \$13.69 per share, and consisted mainly of cash and U. S. Government bonds.

\*Current assets as used herein include cash, U. S. Gov't, and other marketable securities; notes and accounts receivable, less reserves; crude oil and refined products at lower of cost or market. Excluded are "materials and supplies" and "other current assets." A debt of \$28,853,316 owed by Prairie Oil & Gas Company to Prairie Pipe Line Company has been treated as a current liability of Prairie Oil & Gas Company and a current asset of Prairie Pipe Line Company.

<sup>216</sup> Hunter Marston stated (op. cit. supra, note 1, at 2877):

A. \* \* \* Before the consolidation was effected between Prairie Oil & Gas and Prairie Pipe Line Company and Sinclair Company, a study was made by the so-called Rockefeller interests and consent was obtained for the consolidation of the two companies \* \* \*.

W. S. Fitzpatrick testified (op. cit. supra, note 31, p. 3323):

Q. \* \* \* Are the Rockefellers interested in the Sinclair Oil?

A. It is my understanding that they are, when it came to voting in the stockholders meetings of the Prairie Oil & Gas Co. to approve this consolidation, I voted their stock.

them,<sup>217</sup> and some viewed it with such disfavor that they had recourse to the courts.<sup>218</sup>

The Prairie stock held by the Petroleum Corporation was, of course, voted in favor of the consolidation, although the question was never laid before the Corporation's stockholders, but was decided at a meeting of the Corporation's Executive Committee held in February 1932.<sup>219</sup> It was reported to the Executive Committee of Petroleum Corporation that Bancamerica-Blair Corporation would receive \$700,000 as a fee for its services in connection with the consolidation.<sup>220</sup> A committee was appointed to urge on Bancamerica-Blair, Petroleum Corporation's right to share in the fee by reason of the valuable services rendered by Petroleum Corporation's officers.<sup>221</sup> As a result, after long negotiation, the sum of \$90,000 was finally paid to Petroleum Corporation by Bancamerica-Blair.<sup>222</sup>

<sup>217</sup> Under date of February 15, 1932, a letter was sent out to the stockholders of Prairie Pipe Line Company by an independent group calling itself "Stockholders Protective Committee" in which the following pertinent question was posed:

Should the Prairie Pipe Line stockholders subordinate their present common stock equities to a bonded indebtedness of another company of approximately \$66,000,000, in addition to cumulative 8% preferred stock of over \$14,000,000, and exchange their present common stock equities, unincumbered, as follows:

Net Current Assets, per share-----	\$6.51
Additional Current Assets, due from Prairie Oil & Gas Company, per share (loans, notes, and accounts receivable of \$28,853,316.80)-----	7.12
Making a total of net liquid assets, as above, per share-----	13.63
For common stock equities in the new company to be known as Consolidated Oil Corporation (subordinated to the bonded indebtedness and cumulative 8% Preferred Stock, as aforementioned) equal to (per share)-----	5.15
If you are OPPOSED to surrendering \$8.48 of net liquid assets, per share, for an equal or larger amount of other assets (mostly fixed) you should vote NO. (Supplementary information supplied the Commission for Petroleum Corporation of America.)	

<sup>218</sup> In addition to the suits mentioned by Mr. Fitzpatrick in the testimony set forth above, *The New York Times* on May 21, 1932, reported (at p. 22) that a stockholder named William R. Carney had filed a petition in equity in the Federal District Court, Northern District of Illinois, in Chicago, Illinois, asking that a receiver be appointed for Consolidated Oil Corporation.

<sup>219</sup> Op. cit. supra, note 1, Commission's Exhibit No. 336. The executive Committee of Petroleum Corporation at this time included Charles Hayden (of Hayden, Stone & Co.), John H. Markham, Jr., Elisha Walker, and H. H. Rogers, all members of the Bancamerica-Blair and Sinclair group.

<sup>220</sup> With respect to the services rendered by Bancamerica-Blair Corp. for which this fee was intended to compensate, Hunter Marston stated (op. cit. supra, note 1, p. 2878): "A great deal of work was done in connection with trying to convince both sides that it ought to be effected, and many trips were made and studies of the situation. It involved, I think, a period of over a year and a half's work, and it was finally demonstrated that it was the proper thing to do and a very advantageous thing to do."

<sup>221</sup> Ibid.

<sup>222</sup> In considering this instance of self-assertion by Petroleum Corporation against its sponsor, Bancamerica-Blair Corp., it will be recalled that at this period Elisha Walker was in the midst of his struggle with A. P. Giannini for control of Transamerica Corporation, which controlled Bancamerica-Blair, a struggle which Mr. Walker definitely lost on Feb. 16. (See supra.) At the hearings before this Commission, Mr. Walker conceded that he played a part in procuring the payment for Petroleum Corp. Mr. Walker testified (op. cit. supra, note 1, at 3023):

At the time of this resolution, Feb. 1, I was still technically, I think, a director of Bancamerica, but on the 15th of February I ceased to be, and the settlement, if I remember right, was made after the 15th of February and while I wasn't a member of the [negotiating] Committee, I took, I think I took part in getting for Petroleum Corporation the \$90,000 or whatever it was that they received.

Q. There were quite a bit of discussions with regard to that?

A. Pretty strong discussions on that.

Q. Who resisted the payment?

A. I suppose each one was protecting their own interest.

## 7. PETROLEUM CORPORATION INCREASES POSITION IN CONSOLIDATED OIL CORPORATION; CONSOLIDATED OIL CORPORATION INCREASES ITS POSITION IN PETROLEUM CORPORATION

Petroleum Corporation received for its holdings in the Prairie companies and in Sinclair Consolidated Oil Corporation following the consolidation <sup>223</sup> 1,466,340 shares of stock of Consolidated Oil Corporation. This block constituted more than 10% of the total 14,218,835 shares of Consolidated Oil Corporation outstanding, after giving effect to the consolidation. The 1,466,340 shares of Consolidated Oil Corporation stock received by Petroleum Corporation had a market value at the end of 1932, the year of their issuance, of \$7,881,577.<sup>224</sup> On June 4, 1932, shortly after the consolidation, the market value of this stock had been \$5,865,360. Since this block of Consolidated Oil Corporation stock had cost Petroleum Corporation \$64,733,540,<sup>225</sup> Petroleum Corporation had an unrealized loss on its investment of 88% at the end of 1932.

Despite this tremendous unrealized loss in the concentrated holdings of this stock, during the following year (1933) Petroleum Corporation made additional purchases of the shares of Consolidated Oil Corporation to the extent of 116,000 shares. By the end of 1935, Petroleum Corporation's holdings of the stock of Consolidated Oil Corporation totaled 1,582,340 shares and equaled 11.3% of the total outstanding shares.

The result of this investment concentration is indicated by the following table which gives the amounts of the concentrated holdings of shares in the Prairie and Sinclair Oil Companies and their successor, Consolidated Oil Corporation, and their percentages to the total portfolio of Petroleum Corporation, at cost and market values, at three year-end dates.<sup>226</sup>

Year-end	Cost			Market		
	Entire portfolio	Concentrated holdings	Percent	Entire portfolio	Concentrated holdings	Percent
1929.....	\$86,345,785	\$66,350,370	76.8	\$83,819,844	\$66,407,950	79.2
1932.....	88,102,677	64,733,540	73.5	14,552,141	7,881,578	54.2
1935.....	84,549,794	64,028,272	75.7	33,509,729	18,998,080	56.7

The balance of the portfolio, consisting of common stocks of a diversified group of oil companies, made a much better showing on a percentage basis than did these concentrated holdings. The former group at the end of 1935 showed a loss of only 30% as compared with a loss for the concentrated holdings equal to 70%, as is demonstrated by the following comparisons at the end of the same three years.

<sup>223</sup> Reply to the Commission's questionnaire for Petroleum Corporation of America, Table 2.

<sup>224</sup> Ibid.

<sup>225</sup> Ibid.

<sup>226</sup> Ibid.

*Unrealized loss or gain*

Concentrated holdings			Balance of portfolio	
Dec. 31	Amount	Percent of cost	Amount	Percent of cost
1929.....	+\$57,580	+0.1	-\$2,583,521	-12.9
1932.....	-56,851,962	-87.8	-16,698,574	-71.5
1935.....	-45,030,192	-70.3	-6,009,873	-29.3

Subsequent to 1932, at the same time that Petroleum Corporation was increasing its holdings in Consolidated Oil Corporation, Consolidated Oil Corporation was adding substantially to its holdings of the stock of Petroleum Corporation. By the end of 1935, its initial block of 500,000 shares of Petroleum Corporation stock which Sinclair had purchased from Blair & Co. had been increased to 781,276 shares.<sup>227</sup> By reason of Petroleum Corporation's heavy repurchases of its own stock, Consolidated Oil Corporation's holdings also increased with extraordinary rapidity percentagewise and, at the end of 1935, amounted to 39% of the total outstanding shares of Petroleum Corporation.<sup>228</sup> As the result, Consolidated Oil Corporation, at the end of 1935, owned a 39% interest in Petroleum Corporation and Petroleum Corporation in turn owned an 11.3% interest in Consolidated Oil Corporation, and each corporation was by far the other's largest stockholder.<sup>229</sup>

This situation intensified the system of reciprocal ownership between the two corporations previously commenced<sup>230</sup> and established a circular arrangement by which the management of these corporations was aided in perpetuating its control over both.<sup>231</sup> Concerning this situation, Hunter Marston testified:<sup>232</sup>

Q. The situation at the present time is, is it not, Mr. Marston, that Consolidated Oil Corporation owns approximately 39% of Petroleum Corporation, which in turn owns approximately 11.3% of Consolidated Oil Corporation. Isn't that so?

A. I believe that is correct.

Q. The merger has been effected, has it not?

A. Yes, sir.

<sup>227</sup> Derived from supplementary information supplied the Commission for Petroleum Corporation of America.

<sup>228</sup> *Op. cit. supra*, note 1, at 2852.

<sup>229</sup> The next largest stockholder of Sinclair Consolidated Oil Corporation owned only 120,000 shares, equal to 1.29% of the total outstanding. (Derived from supplementary information supplied the Commission for Petroleum Corporation of America.)

<sup>230</sup> See discussion of the commencement of this system, *supra*, pp. 275-6.

<sup>231</sup> It is obvious that under such an arrangement the difficulties of a successful stockholders' opposition are greatly increased, for a successful attempt to dislodge this control would necessarily require that it be launched simultaneously in both corporations, in order to avoid being crushed by the reciprocal influence of the management. For a case where a court of chancery enjoined the consummation of a similar circular arrangement between two corporations, see *Robotham v. Prudential Ins. Co. of America*, 64 N. J. Eq. 673, 53 A 842 (1910).

<sup>232</sup> *Op. cit. supra*, note 1, at 2859.

Q. And I assume one of the purposes of the trust has been accomplished, namely, the effecting of the merger which took place in March 1932?

A. Yes.

Q. Do you know the reason why Petroleum still holds that 1,582,000 shares of Consolidated Oil Corporation stock?

A. I think, it is my hope, speaking individually that this Consolidated Oil stock is eventually going to retrieve its decline and that this consolidation will achieve a pretty good record of earnings \* \* \*.

Q. Here we have a situation, Mr. Marston, where over 60% of the stockholders' interest in Petroleum Corporation is represented by the Consolidated Oil Company, isn't that so?

A. Correct.

Q. Why—and I am just thinking out loud—isn't Petroleum Corporation dissolved and the stockholders given their aliquot interest in Consolidated Oil Corporation, because substantially that is what they are—stockholders in Consolidated to the extent of over 60% of the assets of Petroleum Corporation anyway.

A. The Petroleum Corporation engages in other activities. They buy and sell shares in other oil companies \* \* \* and the holdings of Consolidated Oil Stock is being continued on the theory that there is going to be an appreciation.

Q. And isn't it also one of the consequences that \* \* \* the dominant interest of the Consolidated Oil Corporation maintains control of the Consolidated Oil Corporation, by virtue of the fact that they control Petroleum Corporation, which in turn controls over 11% of Consolidated Oil; isn't that so?

A. I wouldn't say they controlled. They have a dominant interest so far as percentages go.

Mr. Marston conceded <sup>233</sup> that by reason of the wide diffusion of the Petroleum Corporation stock (the next largest stockholder after Consolidated Oil Corporation owned only 44,600 shares, less than 2½% of the total amount outstanding) <sup>234</sup> that Consolidated Oil Corporation had "potential working control in any situation." He testified further: <sup>235</sup>

Q. By virtue of the fact that they owned this 39% of Petroleum Corporation, which in turn owns 11% of Consolidated Oil Corporation, the [management of] Consolidated Oil Corporation can, if it sees fit, have the stock of Consolidated Oil Corporation owned by Petroleum Corporation voted as they see fit, isn't that so?

A. Subject to—if it were at the request and with the approval of the Board of Directors.

Q. And if the Board of Directors did not do what they were told there would be another election at the end of the year, isn't that so?

A. I don't know. I doubt it.

Q. \* \* \* if the most substantial stockholder, owning 39%, does not like what the board of directors does, he pretty much can turn them out at the next annual election. Is there any doubt about that, Mr. Marston?

A. Well, if there were not a proxy fight.

<sup>233</sup> Id., at 2863.

<sup>234</sup> As at Dec. 31, 1935, Petroleum Corporation had 2,010,160 shares of stock outstanding. (Reply to the Commission's questionnaire for Petroleum Corporation, Item 28.)

<sup>235</sup> Op. cit. supra, note 1, at 2863.

Q. Well, in order to beat him you would have to get substantially every other stockholder of the corporation to oppose him, isn't that so?

A. You would have to get a very substantial amount.

Q. If, on the other hand, Petroleum Corporation were dissolved, and if you had a distribution of its portfolio securities and Consolidated Oil Corporation was to get its proportionate share of the Consolidated Oil Corporation's stocks in the portfolio of Petroleum Corporation, that stock would then become treasury stock and it could not vote it at all; isn't that so?

A. I don't know the legal status on that.

\* \* \* \* \*

Q. The point I am trying to make is, isn't it to the interest of [the management of] Consolidated Oil Corporation that this arrangement be kept alive, because by virtue of their ownership of 39% in the Petroleum Corporation they control 11% of Consolidated Oil Corporation.

A. I don't know. I haven't discussed that situation.<sup>236</sup>

## 8. ADDITIONAL LOSSES SUFFERED BY PETROLEUM CORPORATION IN CONNECTION WITH SINCLAIR'S PLANS; THE RIO GRANDE OIL COMPANY VENTURE

It will be recalled that Sinclair and his banking associates, Blair & Co., at the time they purchased the Prairie stocks from Rockefeller, had in mind a project far more ambitious than consolidation merely of the Prairie companies and Sinclair Consolidated Oil Corporation. Their plans, as Hunter Marston testified,<sup>237</sup> embraced at least three other large oil companies, including Tidewater Associated Oil Corporation and Barnsdall Oil Company. Despite the deepening economic depression, this project was not abandoned readily, and successive attempts were made to accomplish the consolidation. In each attempt Petroleum Corporation was made a participant and in each venture Petroleum Corporation sustained a substantial loss.

<sup>236</sup> On the same subject, Earl Sinclair testified (op. cit. supra, note 1, at 3096) :

Q. Mr. Sinclair, do you see any investment purpose or economic purpose that is being served by the Petroleum Corporation still maintaining that very, very substantial block of Consolidated Oil Corporation?

A. I think that is simply a question of policy. They are in business to make money. At least, that is the way we feel about our investment in that corporation. It is a large block of stock. Whether they could get rid of it advantageously or not is a question. I don't believe they could today.

Q. Was there any discussion as to whether the Petroleum Corporation should attempt to reduce its position in Consolidated Oil Corporation?

A. I think the board of the Petroleum Corporation discussed that. Then the question came up whether they would get more profit than they would in the Consolidated Oil.

Q. I mean, was there any discussion in the Consolidated Oil interests as to the advisability or feasibility of doing that?

A. I have just explained that the board of the Petroleum Corporation naturally discussed the various issues that they had.

\* \* \* \* \*

Q. The Sinclair Consolidated Oil Corporation does not vote its stock, treasury stock, on any matters involving corporate affairs, does it?

A. No.

Q. Of course if there had been a distribution of the Consolidated Oil Corporation shares and Consolidated Oil Corporation was to get its 39 percent of Consolidated Oil Corporation stock, which is held by Petroleum Corporation, of course the Consolidated Oil Corporation could not vote that stock on any matters, could it?

A. Oh, no.

Q. But by virtue of the fact that it owns 39 percent of the Petroleum Corporation, which in turn owns 11 percent of Consolidated Oil Corporation, substantially Consolidated Oil Corporation can vote that stock; isn't that so?

A. We have never seen the necessity yet for the Petroleum Corporation proxies. I might tell you at our last stockholders' meeting we had proxies for something in excess of 10,000,000 shares.

<sup>237</sup> See testimony of Hunter Marston set forth supra, p. 232.

One of these attempts by Sinclair and Bancamerica-Blair Corporation concerned the Rio Grande Oil Company.<sup>238</sup> In December 1929, after Sinclair had become the dominant interest in Petroleum Corporation, Sinclair and Bancamerica-Blair set out to arrange a consolidation of the Rio Grande Oil Company with Sinclair Consolidated Oil Corporation. Petroleum Corporation was made a participant in this new project in which it ultimately sustained a loss of approximately \$410,000.<sup>239</sup>

The dominant management group in Rio Grande Oil Corporation was comprised of three individuals, L. E. Lockhart, C. S. Jones, and L. M. Lockhart.<sup>240</sup> At the start of negotiations between Sinclair and the Rio Grande interests, these three individuals owned 450,000 shares of Rio Grande Oil Corporation stock,<sup>241</sup> of which 225,000 shares were pledged with brokers in California who were demanding additional margin.<sup>242</sup> Bancamerica-Blair Corporation agreed to furnish Messrs. Lockhart, Jones, and Lockhart the funds they needed in return for obtaining control of the Rio Grande Oil Company.<sup>243</sup>

The genesis of negotiations for the consolidation of Rio Grande with Sinclair Consolidated was described in a memorandum by Charles S. Jones, of Lockhart, Jones and Lockhart, as follows:<sup>244</sup>

Early in December 1929 I was in New York negotiating with the Barnsdall Corporation with a view of merging Barnsdall Corporation and Rio Grande Co. Mr. Tinker,<sup>245</sup> who is a member of the Barnsdall board, was fully informed regarding these negotiations. Toward the conclusion of the negotiations Mr. Walker invited me to call on him. He told me that he had been in touch with the Barnsdall negotiations and that he felt a better deal for Rio Grande could be made with the Sinclair Company, and after discussing the matter with him

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<sup>238</sup> Rio Grande Oil Company was incorporated in November 1925 in Delaware as a holding company for the purpose of acquiring all of the outstanding capital stock of the Rio Grande Oil Company, a Texas Corporation. At the end of 1929 Rio Grande Oil Company and its subsidiary companies constituted a complete unit for producing, refining, and marketing petroleum and its products. It owned oil-producing properties in Los Angeles and Santa Barbara Counties, California, and Loving and Howard Counties, Texas, from which it had a net average production in excess of 7,500 barrels per day. The company distributed its gasoline in California, Arizona, Texas, and New Mexico from 26 bulk stations. It had total assets of \$49,000,000 at the end of 1929, and there were outstanding 1,200,000 shares of stock without par value.

<sup>239</sup> This sum, however, is but a fraction of the loss to which Petroleum Corporation was exposed in this venture, and but a fraction of the loss sustained by it in the Prairie and Mission Securities ventures.

<sup>240</sup> In addition to controlling a large block of stock in the Rio Grande Oil Company, these 3 individuals were the executive officers of the corporation: L. E. Lockhart was president, L. M. Lockhart was vice president and secretary, and Charles S. Jones was a vice president and treasurer.

<sup>241</sup> Public Examination, The Equity Corporation, Commission's Exhibit No. 35.

<sup>242</sup> *Ibid.*

<sup>243</sup> *Op. cit. supra*, note 1, at 2993 (testimony of Elisha Walker).

<sup>244</sup> Public Examination, The Equity Corporation, Commission's Exhibit No. 35.

<sup>245</sup> Edward R. Tinker was a member of the Prairie and Sinclair Syndicates through his family corporations, the Famothe Corporation and the Traywin Corporation. Mr. Tinker had been president of Chase Securities Corp. and was a member of the board of directors of Sinclair Consolidated Oil Corporation and Petroleum Corporation, and during the period in question (1930) he was also a member of the Board of Bancamerica-Blair Corporation and chairman of its executive committee. In October 1929 he became president of Interstate Equities Corporation, another investment company sponsored by Bancamerica-Blair Corporation at that time. Mr. Tinker resigned as president of Interstate Equities Corporation in 1932 following disagreements with Wallace Groves, who had become the dominant figure in Interstate Equities Corporation.



for some time he made an appointment for me with Mr. Sinclair, and I called upon Mr. Sinclair; after several days of discussion, in which both Mr. Walker and Mr. Tinker participated, we arrived at the basis of a deal for the merging of the Rio Grande into Sinclair.

The basis of the "deal" which was arrived at was, in substance,<sup>246</sup> that Messrs. Lockhart, Jones and Lockhart would accumulate a block of 700,000 shares of Rio Grande Oil Company stock, amounting to 56.5% of the total stock outstanding, which they would sell to Bancamerica-Blair Corporation on the following terms:

130,000 shares (of the management's holdings) at \$35 per share.

320,000 shares (the remainder of the management's holdings) in exchange for 256,000 shares of Sinclair Consolidated Oil Stock.

250,000 shares (to be newly issued by Rio Grande Oil Co.) at \$17 per share.

In addition to purchasing the 700,000 shares of stock, Bancamerica-Blair agreed to lend to Messrs. Lockhart, Jones and Lockhart \$2,812,500 for a period of six months,<sup>247</sup> plus an additional \$500,000 on demand notes, which loans were to be deducted from the purchase price of the stocks.

Bancamerica-Blair's obligation to perform its purchase agreement with Messrs. Lockhart, Jones and Lockhart was made contingent upon the willingness of Sinclair Consolidated Oil Corporation to carry through a contract which Sinclair Consolidated had simultaneously entered into with Bancamerica-Blair, relative to the Rio Grande Oil Company stock. In this contract<sup>248</sup> Sinclair Consolidated agreed with Bancamerica-Blair that, prior to February 15, 1930, Sinclair Consolidated would take from Bancamerica-Blair the 700,000 shares of Rio Grande to be obtained from Messrs. Lockhart, Jones and Lockhart and would turn over to Bancamerica-Blair in exchange 650,800 shares of Sinclair Consolidated Oil stock. In addition, Sinclair Consolidated undertook to make a general offer of exchange for the 786,000 shares of Rio Grande Oil stock outstanding in the hands of the public on the basis of  $\frac{4}{5}$  of a share of Sinclair Consolidated stock for each share of Rio Grande. Sinclair Consolidated agreed to pay to Bancamerica-Blair \$1.00 per share as a commission on all the outstanding stock which was exchanged on this basis.<sup>249</sup>

The obligations of Sinclair Consolidated Oil Corporation under its contract with Bancamerica-Blair were in turn made contingent upon a satisfactory report by its own representatives after an inspection of the business and properties of the Rio Grande Oil Company.<sup>250</sup>

If these interrelated agreements had been fully performed, the result would have been as follows:

Messrs. Lockhart, Jones and Lockhart would have received \$1,737,500 in cash, after clearing off their bank loans,<sup>251</sup> plus 256,000 shares of Sin-

<sup>246</sup> This deal was set forth in a series of letters exchanged by the various parties concerned and introduced in evidence before the Commission. (Public Examination, The Equity Corporation, Commission's Exhibits Nos. 36a, b, c, b, and e.)

<sup>247</sup> This sum was to enable Messrs. Lockhart, Jones and Lockhart to straighten out their brokerage accounts and procure the release of the 225,000 shares of Rio Grande Oil Company stock which were pledged with the brokers, and which would then be turned over to Bancamerica-Blair as security for the loan.

<sup>248</sup> Public Examination, The Equity Corporation, Commission's Exhibits Nos. 37, 38.

<sup>249</sup> Ibid.

<sup>250</sup> Ibid.

<sup>251</sup> \$4,550,000 received from the sale of 130,000 shares of Rio Grande stock at \$35 less the \$2,812,500 loaned to them by Bancamerica-Blair Corp.



clair Consolidated Oil Company stock which had a market value at the time of \$6,656,000.<sup>252</sup> Bancamerica-Blair and its associates would have paid out \$8,800,000 in cash<sup>253</sup> and would have ultimately ended up in return with 394,800 shares of Sinclair Consolidated Oil Corporation stock<sup>254</sup> which it would have had to divide ratably among the syndicate participants, or for which it would have had to seek some method of disposal without "breaking" the market; in addition, the Bancamerica-Blair group had a potential commission of \$786,000 to be earned on the public exchange of stock. Sinclair Consolidated Oil Corporation would have acquired 700,000 shares of Rio Grande stock, equal to 56.5% of the total outstanding, in exchange for 650,000 shares of its own stock, thus giving it absolute majority control of Rio Grande Oil Company; and in addition, it expected to obtain a large portion of the remaining Rio Grande stock in the hands of the public, on the basis of four shares of Sinclair for each five shares of Rio Grande, which would make possible formal consolidation of Rio Grande with Sinclair Consolidated. Thus, by virtue of these transactions, the management group in Rio Grande would have received \$35 per share for a large portion of its stock when the market price was only \$21 per share and the corporation itself was receiving only \$17 per share; Bancamerica-Blair and its associates would have been left with a block of 394,800 shares of Consolidated Oil stock; and Sinclair Consolidated Oil would have absorbed another oil company with assets of \$42,000,000, at a total cash outlay of \$786,000. Questioned as to the reasons why Bancamerica-Blair<sup>255</sup> was willing to pay to the management group of Rio Grande a price more than twice that which it proposed to pay to the Rio Grande Corporation, Elisha Walker stated:<sup>255</sup>

\* \* \* the only explanation I can see would be this: That if I remember right, Rio Grande stock was selling somewhere around \$20 a share, and the company would have been very happy to have gotten \$17 a share for a block of stock so as to give it the working capital that it could use in this business, and the only other side of the picture that I could see was that the insiders took the position: "Well, if you want control of this company you have got to pay some fancy price for our stock," and that is about the only explanation that I can see for that.

Of course, unfortunately, that has been known to be done by insiders, disposing of a controlling interest at quite a premium.<sup>256</sup>

Bancamerica-Blair's rights and obligations in the Rio Grande Oil Company venture were divided among a four-party syndicate, consist-

<sup>252</sup> 256,000 shares of Sinclair Consolidated in exchange for 320,000 shares of Rio Grande. (See supra.) The market price of Sinclair Consolidated at that time was approximately \$26 per share.

<sup>253</sup> \$4,550,000 in cash to Lockhart, Jones and Lockhart for 130,000 shares of Rio Grande at \$35 per share, and \$4,250,000 to the Rio Grande Oil Company for 250,000 shares of Rio Grande at \$17.

<sup>254</sup> Bancamerica-Blair Corporation would receive 650,800 shares of Sinclair Consolidated Oil stock from that corporation in exchange for the 700,000 shares of Rio Grande. From this amount they would be required to turn over 256,000 shares to Messrs. Lockhart, Jones and Lickhart in exchange for 320,000 shares of Rio Grande stock to complete the purchase price. (See supra.) This would leave Bancamerica-Blair a balance of 394,800 of Sinclair Consolidated.

<sup>255</sup> Public Examination, The Equity Corporation, at 2997.

<sup>256</sup> Mr. Walker stated further with respect to this transaction (id., at 2298): "Bancamerica-Blair weren't their brother's keeper, and it was due or up to the management of Rio Grande and Bancamerica-Blair, as I see it, had no responsibility to the stockholders of Rio Grande \* \* \*."

ing of itself, Sinclair Consolidated Oil Corporation, Interstate Equities Corporation, and Petroleum Corporation of America, each assuming a 25% participation. Like Petroleum Corporation of America, Interstate Equities Corporation was an investment company which had been sponsored and was controlled by Bancamerica-Blair.<sup>257</sup>

By virtue of its 25% participation in the Rio Grande Oil Company venture, Petroleum Corporation undertook a commitment of \$2,200,000 in return for which, if the transaction was consummated, it had the prospect of receiving 98,700 shares of Sinclair Consolidated Oil Corporation stock to add to its already substantial holdings of that stock. On this subject Elisha Walker testified:<sup>258</sup>

Q. So, in addition to the Prairie group, the Prairie Pipe and the Sinclair Consolidated that you purchased in the market, and from other persons \* \* \* you had here a situation that in order to effect a merger between the Sinclair Consolidated Oil Corporation and the Rio Grande, the group [the syndicate] would receive an additional 650,800 shares of Sinclair Consolidated Oil, of which 25 percent would go to the Trust; isn't that so?

A. Twenty-five percent would go to the Petroleum Corporation, unless it was disposed of in the market.

Q. That is correct \* \* \* and the fact of the matter is that was the thing which was hoped for, isn't that so, that the group would wind up with 650,800 shares, or else these agreements wouldn't have been made.

A. I think that they would have disposed of the stock at a profit.

Q. These agreements look forward to the group getting 650,800 shares from Sinclair, with the ultimate hope of disposition; isn't that so?

A. Yes; I presume so.

The transactions envisaged by the contracts never materialized, nor did the profits. Mr. Sinclair began to delay in the performance of the agreements.<sup>259</sup> He told Mr. Jones that he did not wish to proceed at this time with the Rio Grande Oil Company exchange because unforeseen obstacles had developed in working out the consolidation between his company and the Prairie companies, which he considered an inter-related transaction.<sup>260</sup> At the same time, opposition developed within the Rio Grande Oil Company on the part of stockholders who regarded

<sup>257</sup> Interstate Equities Corporation was organized on July 29, 1929, under the laws of the State of Delaware by Bancamerica-Blair Corporation. It commenced operations in October 1929 with \$25,000,000. On June 30, 1932, the assets of the corporation had shrunk to \$4,450,000. On March 26, 1935, the assets and liabilities of Interstate Equities Corporation were taken over by The Equity Corporation. At that time the book asset value of Interstate Equities Corporation totaled \$5,464,608.

Three successive managements controlled the corporation's affairs from its inception until 1935 when The Equity Corporation took it over. The first of these managements was that of Bancamerica-Blair Corporation and Edward R. Tinker, as president July 1929 to June 30, 1932. The second management was that of Wallace Groves, July 1, 1932, to June 30, 1933; the third was that of The Equity Corporation, July 1, 1933, to March 26, 1935. (Public Examination, The Equity Corporation, at 1-500.)

<sup>258</sup> Id., at 3004.

<sup>259</sup> Id., at 3009-10.

<sup>260</sup> Mr. Jones, in his memorandum introduced in evidence before the Commission (Public Examination, The Equity Corporation, Commission's Exhibit No. 35) stated: "A meeting of the Sinclair Company was scheduled to be held in February 1930 for the final approval and consummation of the trade. I returned to New York from California for the purpose of carrying out the details of the merger and was informed by Mr. Sinclair that some unforeseen circumstance had arisen regarding the Prairie deals and because he did not wish one deal to be made unless the other was assured, he would postpone submitting the deal to his directors until some future time."

the price of \$17 per share which was to be paid to the corporation as inequitable in the light of the \$35 price which was to be paid to the management group. As the result of this opposition, the preferential price for the management group had to be eliminated from the contract and a substantial loan for the management substituted in its place.<sup>261</sup>

Despite these serious difficulties, on February 15, 1930, the syndicate made to Messrs. Lockhart, Jones and Lockhart the \$2,812,500 loan provided for in the contract.<sup>262</sup> The entire sum was advanced on behalf of the syndicate by Interstate Equities Corporation, the investment company sponsored by Blair & Co., which received the promissory note of Messrs. Lockhart, Jones and Lockhart and 225,000 shares of Rio Grande Oil Company stock as collateral security.

In April 1930, Rio Grande Oil Company found it necessary to construct steel storage tanks to contain a large quantity of oil which it could not dispose of. The Bancamerica-Blair Syndicate advanced \$5,000,000 for this purpose in the form of a revolving credit.<sup>263</sup> Petroleum Corporation of America contributed as its percentage of this fund the sum of \$1,250,000.<sup>264</sup>

When the note matured on June 30, 1930, Messrs. Lockhart, Jones and Lockhart defaulted in payment.<sup>265</sup> Although the market value of the collateral at that time was adequate to have repaid the syndicate in full, no attempt was made to realize on the collateral, but instead, the syndicate accepted a new demand note in place of the matured note. Elisha Walker testified on this subject as follows:<sup>266</sup>

Q. When the note was not paid you had the 225,000 shares of Rio Grande Oil stock as collateral?

A. Yes.

Q. Did the group foreclose or call for payment of the note?

A. I don't think so.

Q. The collateral at that time would have been sufficient to do that, would it not, Mr. Walker?

A. I really don't remember the prices.

\* \* \* \* \*

Q. But in any event, on June 30, 1930, the note was not paid, the collateral was not foreclosed; isn't that so?

A. Yes.

Q. Of course, if you foreclosed that collateral you would have broken up that substantial block of stock which would have been effective in any subsequent proceedings to merge Rio Grande and Sinclair; isn't that so?

A. Oh, I imagine so.

<sup>261</sup> Elisha Walker testified (op. cit. supra, note 1, at 2998) :

Q. \* \* \* Ultimately, when the stockholders of Rio Grande found out that that was being done, there was a little rumpus created, wasn't there? And, as a matter of fact, this deal was abandoned, and the provision requiring you to purchase the 130,000 shares at \$35 a share was taken out, \* \* \* and a different provision substituted, that you would loan them money on the stock, isn't that so, Mr. Walker?

A. I don't remember all that transpired until you bring it up, but that is right.

<sup>262</sup> Id., at 2999.

<sup>263</sup> Public Examination, The Equity Corporation, at 457.

<sup>264</sup> Reply to the Commission's questionnaire for Petroleum Corporation of America, Schedule 8. This sum was subsequently repaid. (Ibid.)

<sup>265</sup> Op. cit. supra, note 1, at 3011.

<sup>266</sup> Ibid.

**Q.** Wasn't that one of the things that motivated the group, to hold the stock intact; they wouldn't foreclose the collateral so that they could hold that block intact, consummating a merger with Sinclair?

**A.** I think there were a variety of reasons, such as influenced banks generally not to foreclose in the hope they could carry their people through and save a very disastrous situation which was in the making, but in addition to that I think there was undoubtedly in the background that if this situation is worth saving, there is a probable profit in this situation eventually for those interested in the deal, including Petroleum Corporation.

Subsequently in July 1930 Interstate Equities Corporation made formal demand on Messrs. Lockhart, Jones and Lockhart for payment of the entire amount of the note. Although payment was not received, no steps were taken to foreclose the collateral.<sup>267</sup> In the meantime divers new plans for effecting a consolidation between Rio Grande Oil Company and Sinclair Consolidated Oil Corporation were alternately adopted and rejected; and negotiations continued from year to year, while the note remained unpaid.<sup>268</sup> The market price of Rio Grande stock declined from \$21 as of January 1930 to \$2 as of July 1932,<sup>269</sup> while that of Sinclair Consolidated Oil declined in the same period from \$26 to \$5.50.<sup>270</sup> In July 1932 Consolidated Oil Corporation (the consolidation of the Prairie companies and Sinclair Consolidated was effected March 1932) made an offer of exchange to all the stockholders of Rio Grande Oil Company, on the basis of two shares of Consolidated Oil Company stock for five shares of Rio Grande oil stock.<sup>271</sup> This offer of  $\frac{2}{5}$  of a share of Consolidated for each share of Rio Grande was a 50% reduction in the ratio of  $\frac{4}{5}$  for one contemplated by the contracts of January 1930.<sup>272</sup>

On July 12, 1932, the Atlantic Trading Company, Ltd. of St. John's, Newfoundland, a company controlled by Elisha Walker, addressed a letter to Interstate Equities Corporation, the other investment company sponsored by Blair & Co., which stated that "the undersigned Atlantic Trading Company (which Mr. Elisha Walker controls) is endeavoring to obtain options on certain blocks of stock of the Rio Grande Oil Company with a view to offering the same to the Consolidated Oil Corporation for cash \* \* \*"<sup>273</sup>

The Atlantic Trading Company purchased Interstate Equities Corporation's holdings of Rio Grande stock for \$4.25 per share.<sup>274</sup> At the same time Walker arranged to purchase Petroleum Corporation's holdings of Rio Grande stock for \$5.00 per share.<sup>275</sup> Mr. Walker then resold the Rio Grande stock to Consolidated Oil Corporation for \$5.00 a share, making a profit of \$58,000.<sup>276</sup> Petroleum Corpora-

<sup>267</sup> Id., at 3017.

<sup>268</sup> Public Examination, The Equity Corporation, at 469-70.

<sup>269</sup> Op. cit. supra, note 1, at 3020.

<sup>270</sup> Id., Commission's Exhibit No. 345.

<sup>271</sup> Id., at 3017.

<sup>272</sup> See supra, p. 291.

<sup>273</sup> Public Examination, The Equity Corporation, Commission's Exhibit No. 47.

<sup>274</sup> Op. cit. supra, note 1, at 3010. This stock was Interstate Equities Corporation's proportionate share of the collateral pledged by Messrs. Lockhart, Jones and Lockhart as security for the loan of \$2,812,500 advanced by the syndicate, as recounted supra, p. 294. Petroleum Corporation likewise held a block of this stock received from the same source.

<sup>275</sup> Ibid.

<sup>276</sup> Ibid.

tion's loss in the Rio Grande Oil Company venture was approximately \$410,000.<sup>277</sup>

At the time these transactions were effected, Mr. Walker was still chairman of the board of Petroleum Corporation of America and a director of Interstate Equities Corporation. Mr. Walker testified regarding these transactions as follows:<sup>278</sup>

I was then in business for myself. I was no longer connected with Bancamerica-Blair. I was a director by sufferance only of Interstate Equities, the control having passed. I was still a director of Petroleum Corporation. I undertook to see if I could work out some proposition which might be acceptable to the members of this group, and I arranged for the—got an offer—I don't know whether I got an offer, but I made some arrangement anyway with the Sinclair Consolidated whereby they would pay a corporation in which I was interested \$5.00 a share for that stock.

So far as Petroleum Corporation is concerned I was still chairman of its board; I had quite some responsibility in its management, and I paid them the exact price that I received, \$5 a share, less the expenses of the transaction, transfer stamps, etc.

Q. But even with the \$5.00 the Petroleum Corporation lost \$447,000 on that deal; isn't that so?

A. I don't remember the amount.

Q. Now, with respect to Interstate, what transpired?

A. I made a deal with Interstate to buy their stock at \$4.25 per share.

Q. That gave you a profit of 75¢ a share?

A. A gross profit of 75¢ a share, which on their total of 78,550 shares amounted to a gross profit of \$58,875.

Q. And how much did the trust lose? They lost \$447,000; isn't that so?

A. I don't remember what they lost.

\* \* \* \* \*

Q. You were still on the board of Interstate at that time?

A. I was on the board, but not an active factor in any sense of the word. I stayed on by sufferance at Mr. Tinker's request, so long as he was President.

Q. Of course, Bancamerica-Blair brought that piece of business to Interstate Equities.

A. Yes; I think Bancamerica-Blair brought it to Interstate Equities. It was all put in the record and so forth, that I was making a profit. Interstate Equities knew it. I didn't vote. Everything was done. I think, in very proper form \* \* \*.

Although for the other members of the syndicate the Rio Grande venture brought only losses, Sinclair Consolidated Oil Corporation before the end of 1932 had achieved complete acquisition of Rio Grande Oil Company. The Rio Grande Oil Company as a corporate entity was kept alive until 1938 and was used by Sinclair as an effective instrumentality to extend still further his increasingly dominant position in the oil industry. In February 1938 the Rio Grande Oil Company's assets were transferred to the Richfield Oil Corporation

<sup>277</sup> After making complete allowance for all sums received in the form of interest, etc., the corporation officially calculated its loss at \$406,675. (Reply to the Commission's questionnaire for Petroleum Corporation of America, Exhibit A, Schedule S.)

<sup>278</sup> Op. cit. supra, note 1, at 3018.

and the company was thereafter dissolved. The Richfield Oil Corporation had by that time passed into the joint control of Consolidated Oil Corporation and the Cities Service Company.<sup>279</sup>

## 9. PETROLEUM CORPORATION'S LOSS OF \$1,984,844 IN TIDEWATER ASSOCIATED OIL COMPANY VENTURE

The Rio Grande Oil Company venture had barely gotten under way when the Sinclair Bancamerica-Blair group undertook to obtain control for the Sinclair interests of Tidewater Associated Oil Company, one of the oil industry's leading independent companies, possessed in 1930 of assets in excess of \$250,000,000.<sup>280</sup>

In May 1930 Mission Securities, Ltd., was organized by the managing officers of Tidewater Associated Oil Company, to take over a block of 1,078,125 shares of Tidewater common stock which Standard Oil Company of New Jersey held in its portfolio and which it wished to sell.<sup>281</sup> These shares of stock equaled approximately 19% of the total outstanding common stock of Tidewater and, consequently, constituted an effective block.<sup>282</sup> The officers and directors of Tidewater Associated Oil Company were anxious to have this important block of stock "in friendly hands and good hands."<sup>283</sup> Among the directors of Tidewater Associated Oil Company were Hunter S. Marston of Blair & Co., and Halsted G. Freeman of Chase Securities Corporation, both at that time directors of Petroleum Corporation of America.<sup>284</sup>

The newly organized Mission Securities, Ltd., entered into a contract with Standard Oil Company for the purchase of this Tidewater stock for the sum of \$23,147,300. This price equaled \$21.50 per share.

<sup>279</sup> These transactions are summarized in *Moody's Manual of Industrials*, 1938, p. 768, as follows:

In September 1932 Consolidated Oil Corporation acquired all the property, assets, and business of the Rio Grande Oil Company (Del.) subject to certain liabilities of said corporation which were assumed, paying therefor 494,329 shares of Consolidated Oil common stock at the rate of 4/10 of a share of Consolidated Oil common for each share of Rio Grande Oil stock.

Pursuant to an agreement dated January 28, 1936, between the company and Cities Service Company, Rio Grande Company (Texas), being a wholly owned subsidiary of the company, increased its authorized capital stock from 30,000 shares to 60,000 shares and issued said 30,000 additional shares to the Cities Service Company in consideration of the conveyance to Rio Grande of certain undeveloped oil acreage in California \* \* \* and the assignment and transfer to Rio Grande of all securities held by the Cities Service Company in Richfield Oil Company of California and Pan American Petroleum Company \* \* \*.

The Richfield Oil Company and its subsidiary, Pan American Petroleum Company, were reorganized under a plan consummated in March 1937, and Rio Grande Oil Company acquired an interest in Richfield Oil Corporation, the reorganized company, by reason of ownership of the above-mentioned securities and by the transfer to Richfield Oil Corporation of substantially all of its (Rio Grande's) assets.

On February 4, 1938, it was announced that Rio Grande Oil Company had been dissolved following completion of transfer of its assets to Richfield Oil Corporation, in accordance with the merger reorganization plan effected in March 1937. Stock of Richfield Oil Corporation obtained by Rio Grande Oil in exchange for its physical properties has been distributed to Consolidated Oil Corporation and Cities Service Company \* \* \* Consolidated Oil and Cities Service now own 35.78% of Richfield's outstanding common stock, divided 717,469 shares, or 17.89%, to each. In addition, both companies hold \* \* \* option warrants \* \* \* exercisable, some in three years and some in four years.

<sup>280</sup> *Moody's Manual of Industrials*, 1930, p. 1401.

<sup>281</sup> *Op. cit.* supra, note 1, p. 2962.

<sup>282</sup> At the beginning of 1930, Tidewater Associated Oil Company had outstanding 5,755,845 shares of common stock (no par) and 732,845 shares of 6% preferred stock (\$100 par). The preferred stock, however, was nonvoting, except after default of 4 quarterly dividends. (*Moody's Manual of Industrials*, 1930, p. 1401.)

<sup>283</sup> Testimony of Elisha Walker, *op. cit.* supra, note 1, at 2962.

<sup>284</sup> *Moody's Manual of Industrials*, 1930, p. 1401.

while the market price at the time was approximately \$17.50 per share.<sup>285</sup> Thus the price which Mission Securities, Ltd., agreed to pay included a premium above market of about \$4,270,000.

The purchase price of \$23,147,300 was payable in three equal installments of \$7,715,766 each: the first on execution of the agreement; the second on August 15, 1931; and the third on August 15, 1932. All unpaid balances carried interest charges at the rate of 5% per annum. Pending final payment for the stock, the entire block was pledged with the Standard Oil Company as collateral security. If the purchaser defaulted in the payment of any installment of principal or interest, the contract provided that after sixty days Standard Oil Company had the right to declare all installments due and payable, and to sell the stock at private sale without notice, in order to satisfy itself for the unpaid sums, but without any right to proceed against Mission Securities, Ltd., for any deficiency.<sup>286</sup>

By virtue of the provisions of this contract, Mission Securities, Ltd., was not entitled to the possession of a single share of Tidewater stock until the entire purchase price was paid, and failure to pay the entire purchase price would result in forfeiture not only of Mission Securities' contract rights, but also of all monies paid in up to that time on the contract.<sup>287</sup> This was conceded by Hunter S. Marston:<sup>288</sup>

Q. Now, under this agreement Mission was not entitled to a single share of the Tidewater Associated Oil stock unless they had paid the full \$23,000,000, isn't that so?

A. Yes.

Q. So that if they paid the first instalment of approximately \$7,000,000 and paid the second instalment of approximately \$7,000,000 and then defaulted on the last instalment or even an instalment of interest, the contract was terminated and Mission had no claim upon the Standard for a single share of stock, isn't that so?

A. Yes.

Simultaneously with its contract with Standard Oil Company, Mission Securities entered into a contract with Bancamerica-Blair, under which Bancamerica-Blair advanced to Mission Securities the \$7,715,766 required by the latter as a down payment on the stock. In return, Mission Securities gave to Bancamerica-Blair its promissory note for the sum, payable August 15, 1931, and assigned to Bancamerica-Blair as collateral security all of Mission Securities' outstanding capital stock, consisting of ten shares, and all of its interest in the Tidewater stock. Bancamerica-Blair was given broad powers over the disposition of the stock, including the manner in which the stock should be voted in the election of officers, and in questions regarding mergers, consolidations, sale of assets. Bancamerica-Blair was given the right, subject to certain contingencies, to take over Mission Securities' interest in the Standard Oil contract prior to June 1931 by canceling the note and paying the organization expenses of Mission Securities, Ltd.<sup>289</sup>

<sup>285</sup> Public Examination, The Equity Corporation, Commission's Exhibit No. 71.

<sup>286</sup> Id., Commission's Exhibit No. 64.

<sup>287</sup> In the event of foreclosure and sale of the collateral, however, if any surplus remained after Standard had paid itself all sums due to it under the contract plus expenses of the sale and stamp taxes, such surplus would be payable to Mission Securities, Ltd.

<sup>288</sup> Public Examination, The Equity Corporation, at 563.

<sup>289</sup> Id., Commission's Exhibit No. 65.



The contract between Bancamerica-Blair and Mission Securities gave clear evidence in many ways that the Mission venture was integrally interwoven with the consolidation plans of Sinclair.<sup>290</sup> The third paragraph of the contract stated significantly:<sup>291</sup>

Mission agrees that prior to December 15, 1930, it will not engage in any negotiations for any consolidation of Tidewater or any subsidiary with any other corporation or corporations, other than a consolidation approved by Blair, or cause or permit any of the stock covered by the purchase agreement to be voted in favor of, or to consent to, or to participate in, any consolidation not so approved. Any acquisition of stock or assets of one corporation by another corporation, or any merger of corporations, shall be deemed a consolidation within the meaning of this agreement. Blair will, during the period prior to December 15, 1930, endeavor to formulate a plan, acceptable to it and to Mission, and to the Board of Directors of Tidewater, for the consolidation of Tidewater with one or more other corporations, to form a complete and integrated unit.<sup>292</sup>

On the same day that the two contracts described above were entered into, May 29, 1930, Bancamerica-Blair Corporation entered into a syndicate agreement with four other parties governing its contract with Mission Securities.<sup>293</sup> The participants in the syndicate were: Sinclair Consolidated Oil, Chase Securities Corporation, Petroleum Corporation of America, Bancamerica-Blair, and Interstate Equities Corporation. The participation of Bancamerica-Blair was 15%, and that of Interstate Equities Corporation was 10%. Each of the others participated to the extent of 25%. The syndicate agreement, in addition to providing Bancamerica-Blair with the funds required by its contract with Mission Securities, established Bancamerica-Blair as syndicate manager, gave it full powers to work out plans for the consolidation of Tidewater Associated Oil with one or more other corporations, and authorized it to purchase, in its discretion, an additional \$20,000,000 worth of stock of Tidewater Oil Company "or of the stock of any other corporation between which and Tidewater Associated Oil Company negotiations for a merger were pending."<sup>294</sup>

<sup>290</sup> It was admitted at the hearings before the Commission that prior to the Mission Securities venture, Sinclair and Tidewater executives had been engaged in merger negotiations. Hunter Marston stated (Public Examination, The Equity Corporation, at 581): " \* \* \* Mr. Humphreys who was head of the Tidewater, and Mr. Sinclair were discussing a consolidation; in fact, reports were made by each company on that \* \* \*."

<sup>291</sup> Id., Commission's Exhibit No. 65.

<sup>292</sup> With regard to this clause, Hunter Marston testified (Public Examination, The Equity Corporation, at 565-6):

A. \* \* \* I believe also in that contract we had a certain time to offer to them some suggestions with reference to a consolidation, and we had one in mind.

Q. Which one did you have in mind at that time?

A. If I recall, it was the Sinclair and Tidewater.

Q. Then, this was another incident where Bancamerica-Blair was trying to accumulate or get control of a block of stock of another oil company in contemplation of effecting a transfer to the Sinclair interest.

A. Well, I won't exactly accede to that \* \* \*.

<sup>293</sup> Id., Commission's Exhibit No. 66.

<sup>294</sup> Ibid. Apparently in the belief that the plans of the syndicate would not meet with favor in Standard Oil circles, the members of the syndicate agreed that no disclosure was to be made with respect to the syndicate agreement. Under date of May 29, 1930, they signed a supplemental document (id., Commission's Exhibit No. 68) which stated that "in connection with the agreement dated May 29, 1930, between Bancamerica-Blair and Mission Securities, Ltd., the undersigned hereby agree that, unless default is made under said agreement, neither said agreement nor any assignment of the purchase agreement therein referred to shall be filed or recorded prior to August 15, 1931, nor shall notice of the making of said agreement or of the assignment of such purchase agreement be given to Standard Oil Company prior to said date."



The total amount for which Bancamerica-Blair Corporation was authorized to commit the syndicate members by virtue of the agreement was \$43,147,300; \$23,147,000 under the Mission Securities contract, and \$20,000,000 for the market purchase of additional stock. Petroleum Corporation of America, by its participation of 25%, was therefore liable for a commitment of \$10,787,000. At this time Petroleum Corporation was already bound under the terms of the Rio Grande Syndicate agreement for a commitment of \$2,200,000 in another venture designed to further the Sinclair Consolidation plans.<sup>295</sup>

Sinclair and his bankers, Bancamerica-Blair Corporation, were entirely definite and explicit in their understanding as to the plans which Bancamerica-Blair, as the syndicate managers, were to seek to effectuate. In a letter written to Sinclair Consolidated Oil Corporation by Bancamerica-Blair on the same date as the three agreements discussed above, Bancamerica-Blair stated:<sup>296</sup>

As managers of said syndicate, we will keep you informed and not take any important action under said syndicate agreement, whether in regard to consolidation or otherwise, involving questions of policy or any commitment in excess of \$500,000, without consulting you and obtaining your consent. \* \* \* We hereby agree that as managers of said syndicate we will use our best efforts to work out a plan for the consolidation of Sinclair Consolidated Oil Corporation with the Tidewater Associated Oil Company, and that we will not, as such syndicate managers, negotiate for any consolidation of Tidewater Associated Oil Company with any other corporation unless and until the same is approved by you.

As a result of this understanding between Sinclair Consolidated and Bancamerica-Blair, the managers of the syndicate, the other members of the Mission Syndicate, became participants in a venture restricted merely to the possibility of a consolidation of Tidewater Associated Oil Company and Sinclair Consolidated Oil Corporation. This was conceded by Elisha Walker:<sup>297</sup>

Q. There was this limitation, although the Sinclair Consolidated Oil Corporation hadn't put up one nickel more than Petroleum Corporation, had it?

A. No.

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<sup>295</sup> To obtain a more precise picture of Petroleum Corporation's situation at this time, it must be recalled that at the end of 1929 Petroleum Corporation had paid out \$64,356,595 for its holdings of the Prairie stocks and \$1,993,775 for Sinclair Consolidated Oil stock. In 1930, in connection with the Rio Grande venture, it contributed \$1,250,000 to the \$5,000,000 revolving fund set up by the syndicate for the Rio Grande Oil Company. (See *supra*, pp. 289-97.)

In addition, apparently in connection with the Mission venture, to assure Sinclair's control over Tidewater Associated Oil Company, Petroleum Corporation early in 1930 began to accumulate the stock of Tidewater Associated Oil Company. By the end of 1930 Petroleum Corporation had purchased a total of 201,000 shares of Tidewater Associated for the aggregate price of \$2,433,347. These purchases were continued throughout 1931, and as of December 31, 1931, Petroleum Corporation held 323,000 shares of Tidewater Associated at an aggregate cost of \$2,938,870.

In consequence, Petroleum Corporation's financial undertakings in connection with Sinclair ventures at this period totaled \$83,546,240 (not including the cost of the Vacuum Oil stock purchased from Sinclair Consolidated for \$4,200,000; see *supra*, p. 277.)

Following the collapse of the Mission Securities venture, 300,000 shares of Petroleum Corporation's holdings of Tidewater Associated Oil stock were disposed of to Getty, Inc., in the manner which has been recounted *supra*, note 149.

<sup>296</sup> Public Examination, The Equity Corporation, Commission's Exhibit No. 69.

<sup>297</sup> *Op. cit. supra*, note 1, at 2974-7.

Q. And yet Sinclair Oil Corporation could prevent the syndicate from taking any action of any consequence with respect to this commitment in the Tidewater Associated Oil.

A. I don't agree with you on the question of disposition of the stock. I agree with you that they could not have spent more than \$500,000 of the \$20,000,000 without consulting them.

Q. Suppose they had received an offer of consolidation from some other interest, with respect to Tidewater Associated Oil Corporation, which would have been more advantageous than the terms offered by the Sinclair Consolidated Oil Corporation, could you have gone through with it without the Sinclair Consolidated Oil Corporation's consent?

A. Not during that period, but consolidations don't come that easy \* \* \*.

Q. \* \* \* even if all of the other participants wanted to effect a consolidation with some other company, the Sinclair Consolidated Oil Corporation, although it only had one quarter participation, could refuse to approve it and prevent that consolidation, isn't that so?

A. They could during that period of the syndicate.

Q. So that they [Sinclair interests] were in a position that they could block any consolidation except with themselves during that period.

A. They were in that position; yes.

Q. And even though the terms that might be offered by some other company with respect to consolidation were better than the Sinclair Consolidated Oil Corporation, if they wanted to say no, that was the end of that.

A. If they wanted to be arbitrary, yes; it is very definitely in the letter.<sup>298</sup>

The Mission Securities venture was a complete loss to the syndicate. On May 29, 1930, the syndicate members furnished to Mission Securities the sum of \$7,715,766, which the latter paid over to Standard Oil Company as its initial contract payment.<sup>299</sup> Petroleum Corporation's contribution to this payment was \$1,984,884.<sup>300</sup> At a later date, an interest payment of \$525,275 was made, of which \$135,818 was paid by Petroleum Corporation.<sup>301</sup>

The second payment of principal, in the sum of \$7,715,766 was due on August 15, 1931, pursuant to the provisions of the contract between Mission Securities and Standard Oil.<sup>302</sup> In the interval, the market price of Tidewater Associated Oil stock declined from \$17.50 per share to approximately \$2.25 per share and the dividend on the Tidewater stock was discontinued.<sup>303</sup> All hope of effecting a consolidation at this time of Tidewater Associated and Sinclair Consolidated was completely abandoned.<sup>304</sup>

<sup>298</sup> In similar vein Hunter Marston testified (Public Examination, The Equity Corporation, at 581) :

Q. So wasn't this entire group aggregating \$43,000,000 put in the control of Sinclair Consolidated Oil Corporation by the commitment?

A. That interpretation is possible \* \* \*.

<sup>299</sup> Op. cit. supra, note 1, at 2978.

<sup>300</sup> Reply to the Commission's questionnaire for Petroleum Corporation of America, Exhibit A, Schedule 8.

<sup>301</sup> Ibid.

<sup>302</sup> See supra, pp. 297-8.

<sup>303</sup> Op. cit. supra, note 1, at 2980.

<sup>304</sup> The reasons for the failure of negotiations for the consolidation of Sinclair Consolidated and Tidewater Associated were not definitely determined at the hearings, but doubtless the collapse of market values coupled with severely unfavorable economic conditions were factors which contributed to this failure.

At the level to which the Tidewater Associated stock had sunk in the market, the initial payment of \$7,715,766 which Mission Securities had made to Standard Oil in May 1930 represented a sum more than three times as great as the total market value of the stock in June 1931. Under these circumstances, none of the syndicate participants was willing to proceed any further with the venture.

On June 6, 1932, Mission Securities wrote to the Standard Oil Company urging that it be granted a three-year moratorium in further payments. After reciting the changed economic situation and the severity of the decline in Tidewater stock, the letter concluded:<sup>305</sup>

The certificates representing said 1,078,123 shares of stock are in your possession and held as security for the payment of the balance of the purchase price, and with this agreement to pay you all dividends that may accrue or be paid on the stock during the moratorium. Mission will merely retain the legal right to hold the stock during the said period, a consideration for which it has already paid the large consideration of \$8,241,041.48. Even though the down payment already made represents a large portion of the total purchase price and is equivalent to approximately three times the present market value of the securities, it is obviously impossible under present conditions for Mission to refinance this purchase contract. The situation in the oil industry is so well known to you that we believe you will not be averse to granting this additional period of time to Mission to carry out its obligations. Your granting this request will permit Mission to avoid a great loss at this time, and afford it an opportunity of completing the transaction under more favorable conditions.

Standard Oil Company's reply was brief and unequivocal. Under date of June 20, 1929, it wrote:<sup>306</sup>

Your letter of the sixth instant in which you request a three-year moratorium on payments of both principal and interest, with a corresponding deferment of the payment of instalments and a waiver of interest was duly received. After full consideration, our Board has concluded not to grant your request, and is expecting you to comply with your contract obligations.

Mission Securities sent William F. Humphrey, vice president of Tidewater Associated Oil Company, as its personal representative to intercede with the officers of Standard Oil Company.<sup>307</sup> Humphrey first suggested that if the moratorium were not granted the contract should be canceled and the total consideration of \$8,241,041 should be returned, "as the purchaser had received no benefit from the contract and the seller had suffered no loss."<sup>308</sup>

The Standard Oil representatives stated that the board of directors would not consider returning any part of the consideration.<sup>309</sup> Humphrey then suggested that the Standard Oil Company deliver to Mission Securities as many shares of Tidewater stock, calculated at the per-share contract price, as the full amount of the cash payment theretofore made would pay for. The Standard Oil representatives

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<sup>305</sup> Public Examination, The Equity Corporation, Commission's Exhibit No. 71.

<sup>306</sup> Id., Commission's Exhibit No. 74.

<sup>307</sup> Id., Commission's Exhibit No. 75.

<sup>308</sup> Ibid.

<sup>309</sup> Ibid.

replied that their company would not consider reducing the number of shares held in the block covered by the purchase agreement.<sup>310</sup> Finally, Mr. Humphrey was informed that the board of directors of Standard Oil Company refused to grant the moratorium, and also refused to return any part of the consideration or to deliver shares of the common stock of Tidewater Associated Oil Company in return for the consideration paid.<sup>311</sup>

The syndicate was compelled to permit Standard Oil Company to declare a forfeiture of every dollar that was paid by the participants. Petroleum Corporation's net loss in this venture was \$1,984,844.77,<sup>312</sup> a sum which nevertheless was less than 20% of the amount which it might have lost by reason of its liability under the syndicate agreement. This was conceded by Hunter Marston in his testimony before the Commission:<sup>313</sup>

Q. Let us see if we can see what has transpired up to the present time. They made an agreement on May 9, 1930, which involved this commitment of \$43,000,000; isn't that so?

A. Yes. That is a potential commitment. There was an actual commitment of \$23,000,000.

Q. This rapid decline [in the market price of the Tidewater stock] could have taken place after the second instalment; isn't that so? I mean, you were lucky it happened after only the first payment, or else you would have been in for \$14,000,000?

A. That seems a fairly accurate conclusion.

\* \* \* \* \*

Q. And by the time the second modified instalment became due you had paid sufficient money on your first instalment to pay for the entire block; isn't that so?

A. At the market price; that is so.

Q. At the market price; and for that \$7,000,000 payment you never received a single share of Tidewater stock. The only thing you had was your contractual obligation to get the million shares, provided you paid the \$23,000,000; isn't that so?

A. That is according to the contract.

Elisha Walker testified to the same effect as to the outcome:<sup>314</sup>

Q. And ultimately the entire agreement was abandoned and the \$7,719,000 was completely lost, except with one possible saving feature,<sup>315</sup> isn't that so; when

<sup>310</sup> Ibid.

<sup>311</sup> Ibid.

<sup>312</sup> The total of Petroleum Corporation's payments was \$2,064,760.38 (principal and interest). It received back a payment of \$55,782.98 and a payment of \$24,092.63, probably as its share of dividends received on the Tidewater stock by the syndicate prior to discontinuance of Tidewater dividends. The net loss was thus \$1,984,884.77. (Reply to the Commission's questionnaire for Petroleum Corporation of America, Exhibit A, Schedule 8.)

<sup>313</sup> Public Examination, The Equity Corporation, at 887-9.

<sup>314</sup> Op. cit. supra, note 1, at 2981-2.

<sup>315</sup> At the end of 1935, Petroleum Corporation acquired from Revada a 10% interest in an option held by Revada Corporation which gave Revada the right to purchase on or before December 31, 1937, 250,000 shares of common stock of Tidewater Associated Oil Corporation for \$3,575,000 (\$14.30 per share) which option was exercisable as a whole only. (Op. cit. supra, note 1, Commission's Exhibit No. 335.) Mr. Marston was of the opinion that this option might make possible the recoupment of a portion of the corporation's loss in the Mission Securities venture. (Public Examination, The Equity Corporation, at 598.)

the agreements were terminated, the syndicate did not get a single share of Tidewater Associated Oil stock?

A. That is right.

Q. And Petroleum Corporation did not get a single share of Tidewater Associated Oil stock, and dropped approximately \$2,000,000; isn't that so?

A. That is right.

Q. And that was all in connection with an attempt to merge Tidewater Associated Oil with Sinclair Consolidated, substantially; isn't that so?

A. I don't agree that that is the limitation that you should place on the merger, or on the freedom of action to sell the stock if the market had gone up.

The participation of Petroleum Corporation in a venture of such magnitude and speculative qualities is explicable only in terms of the affiliations of the investment company's directors and dominating influences. At this period, Sinclair Consolidated Oil Corporation had become, as Earl W. Sinclair conceded,<sup>316</sup> Petroleum Corporation's largest stockholder and its dominant influence. Elisha Walker, chairman of Petroleum Corporation's board of directors was also chairman of the board of Bancamerica-Blair Corporation, a director of Sinclair Consolidated Oil Corporation, a director of Interstate Equities Corporation, and chairman of the board of Transamerica Corporation.<sup>317</sup> Hunter Marston, president of Bancamerica-Blair Corporation, was a director of Petroleum Corporation, a director of Tidewater Associated Oil Corporation, and a director of Interstate Equities Corporation.<sup>318</sup> Edward R. Tinker, a director of Petroleum Corporation, was also a director of Sinclair Consolidated Oil Corporation, and president of Interstate Equities Corporation.<sup>319</sup>

Hunter Marston, seeking to explain why these various ventures revolved around the person of Harry Sinclair, based his explanation on the circumstance that Sinclair "has had his nose, so to speak, in a good many situations." He testified:<sup>320</sup>

A. Well, we thought that we knew a good deal about oil stocks, and Mr. Tinker, the president of the Chase Securities Corporation, after we had invited him to come as president of the Interstate, his firm and ours had been bankers for Sinclair, so naturally, in many of the things that Sinclair was interested or involved in were discussed with us, and being bankers on the situations which we would hear about, we would take up with him all of the Tidewater or such other oil propositions as we had. So that that probably accounts for the fact that Sinclair's name, as you say, sticks out in all of these situations.

Q. I am vitally interested in that situation, as a matter of principle, aside from the specific application.

A. I think that the explanation is that probably Mr. Sinclair over a number of years had been one of the most active men from the standpoint of investigat-

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<sup>316</sup> Op. cit. supra, note 1, at 3085.

<sup>317</sup> Mr. Walker testified (*id.*, at 2970) :

Q. In any event, you were on the Sinclair Board, you were associated with Petroleum Corporation, Interstate Equities, and Bancamerica-Blair, which was the sponsor of Interstate Equities, and sponsor of the Petroleum Corporation, and one of the bankers for the Sinclair interests; isn't that so?

A. Yes.

<sup>318</sup> Public Examination, The Equity Corporation, at 582.

<sup>319</sup> *Ibid.*

<sup>320</sup> *Id.*, at 605.

ing other properties. That property was built up as you probably recall from nothing to one of the third largest corporations today, and so he has had his nose, so to speak, in a good many situations.<sup>321</sup>

## H. Investors' Experience

The investing public in January 1929 paid \$110,500,000 for the shares of Petroleum Corporation of America.<sup>322</sup> As of December 31, 1935, Petroleum Corporation possessed net assets at market of \$34,413,892.<sup>323</sup> The sum of \$14,469,322 had been paid out by the corporation in repurchases of its own stock,<sup>324</sup> and the sum of \$7,059,575 had been paid out as dividends.<sup>325</sup> After giving effect to these deductions, the aggregate loss, realized and unrealized, to the investing public at the end of 1935 was \$54,058,000. The investor who paid \$34 per share in January 1929 and who remained a stockholder throughout the intervening years received dividends of \$2.83 per share, and emerged December 1935 with a share of stock whose asset value was \$17.12<sup>326</sup> and whose market value was \$14.<sup>327</sup> The net loss to the shareholders on that date equaled approximately 50% based on asset value and 59% based on market value, before dividends, and 41.4% and 49.5%, respectively, after allowing for dividends.

The stockholder of Petroleum Corporation of America who was both able and willing to retain his stock during the economic and corporate vicissitudes of the years 1929 to 1935, inclusive, benefited greatly from the repurchases by Petroleum Corporation from those of its stockholders who relinquished their stock during that period. It has already been shown<sup>328</sup> that Petroleum Corporation repurchased

<sup>321</sup> Mission Securities, Ltd., in connection with which Petroleum Corporation lost approximately \$2,000,000 in the manner described above, must not be confused with Mission Corporation, a corporation organized in 1934 by Standard Oil Company as part of a plan to distribute ratably to its stockholders the block of Tidewater stock which Mission Securities failed to take up. In 1934 Standard Oil Company transferred 1,128,123 shares of Tidewater common stock to Mission Corporation in exchange for 1,128,123 shares of Mission Corporation's shares. In January 1935 Standard Oil declared a dividend to its stockholders of four shares of Mission Corporation stock for each seventy-five shares of Standard Oil stock.

<sup>322</sup> See supra, p. 230 et seq.

<sup>323</sup> Reply to the Commission's questionnaire for Petroleum Corporation of America, Exhibit A. As of December 31, 1938, total assets of Petroleum Corporation were \$25,747,658. There were outstanding in the public's hands 1,963,200 shares of stock. (Annual report for the year 1938, Petroleum Corporation of America.)

<sup>324</sup> See supra, p. 278.

<sup>325</sup> The Corporation paid the following dividends per share to its stockholders (reply to the Commission's questionnaire for Petroleum Corporation of America, Item 39):

1929-----	\$0. 37 1/2
1930-----	1. 12 1/2
1931-----	0. 50
1932-----	No dividend
1933-----	No dividend
1934-----	0. 50
1935-----	0. 33

<sup>326</sup> Reply to the Commission's questionnaire for Petroleum Corporation of America, Item 28.

<sup>327</sup> At the end of 1938 (December 31) the net asset value per share of Petroleum Corporation was \$13.08, but allowance must be made for the fact that 1/5 share of Consolidated Oil Corporation stock was distributed for each share of stock held by the stockholders of Petroleum Corporation on Sept. 26, 1938. The market value of this distribution was \$1.80. As of December 31, 1938, the market price of Petroleum Corporation stock was \$9%.

<sup>328</sup> See supra, p. 278.

a total of 1,239,840 shares (equal to 37.7% of the total number issued) for the aggregate sum of \$14,469,322, an average of \$11.67 per share. For these 1,239,840 shares the original stockholders had paid \$42,154,560.<sup>329</sup> The loss of \$27,685,260 suffered on these shares redounded to the advantage of the remaining shareholders to the extent of from \$4,600,000 to \$6,000,000, by which sum asset value of the repurchased shares exceeded cost to the corporation.<sup>330</sup>

The decline in Petroleum Corporation's net assets from the initial capital of \$100,750,000 to \$34,413,892 as of December 31, 1935, equaled 66% of the original contributed capital and 60% of the net contributed capital as of 1935 (original contribution less \$14,469,000 expended by the corporation for repurchases of its own stock).

An overwhelming portion of the total loss suffered by Petroleum Corporation was the direct consequence of ventures and investments which the corporation made, evidently under the dictation of its dominant influences, Harry F. Sinclair and his banking associates of Blair & Co., Inc., and Bancamerica-Blair Corporation. The Prairie Oil & Gas Company, The Prairie Pipe Line Company and the Consolidated Oil Corporation transactions alone accounted at the end of 1935 for a loss of \$45,040,192;<sup>331</sup> and the Mission Securities and Rio Grande Oil Company ventures accounted for \$2,391,559 additional.<sup>332</sup>

Although the prospective stockholders of Petroleum Corporation of America in 1929 were not apprised that it was the intention of the sponsor to use the corporation's funds in furtherance of Sinclair's aspirations in the oil industry, and although the name of Sinclair never appeared in connection with the company's organi-

<sup>329</sup> On the basis of \$34 per share, the issuing price in January 1929.

<sup>330</sup> This figure is an approximate estimate, computed on the basis of a comparison of the asset value per share at each year (reply to the Commission's questionnaire for Petroleum Corporation, Table 7a) with the average cost per share repurchased each year, as shown in the following table:

*Petroleum Corporation of America—Repurchase of corporation's capital stock*

(1) Year	(2) Number of shares	(3) Percent of total sold	(4) Aver- age cost per share	(5) Total amount (cost)	(6) Approx- imate year- end market price	(7) Asset value per share end of year	(8) Total amount (asset value)	(9) Estimated excess of asset value over cost of shares re- purchased
1929 .....	312,100	9	\$23.96	\$7,478,500	\$20	\$31.75	\$9,909,175	\$2,430,675
1930 .....	202,300	6	10.74	2,173,500	67 $\frac{1}{8}$	13.82	2,795,786	622,286
1931 .....	389,140	12	5.86	2,278,900	3 $\frac{1}{8}$	6.52	2,537,193	258,293
1932 .....	160,400	5	5.71	916,600	4 $\frac{1}{8}$	7.23	1,159,692	243,092
1933 .....	45,800	1.4	7.51	344,200	9 $\frac{1}{2}$	14.14	647,612	303,412
1934 .....	52,800	1.6	9.74	514,100	9 $\frac{1}{4}$	12.56	663,168	149,068
1935 .....	77,300	2.4	9.88	763,500	14	17.12	1,323,376	559,876
Total ...	1,239,840	38	11.67	14,469,300	9 $\frac{1}{2}$	14.73	19,036,002	4,566,702

<sup>a</sup> Average.

<sup>331</sup> Reply to the Commission's questionnaire for Petroleum Corporation of America, Table 2. As of December 31, 1935, Petroleum Corporation owned 1,552,349 shares of Consolidated Oil stock (of which 1,466,340 shares had been received in exchange for its holdings of Prairie Oil & Gas, Prairie Pipe Line and Sinclair Consolidated stock) whose cost to the corporation was stated in the questionnaire as \$64,028,272.50. The market value at that date was \$18,988,080. (Ibid.)

<sup>332</sup> Petroleum Corporation's loss in the Mission Securities syndicate, after allowing for all returns, was \$1,984,884. Petroleum Corporation's loss in the Rio Grande syndicate—after allowing for all returns, was \$406,675. (Reply to the Commission's questionnaire for Petroleum Corporation of America, Balance Sheet, Schedule 8.)

zation, or its operations until 1932,<sup>333</sup> approximately 88 cents out of every dollar which the investment company possessed from its inception until 1938 were either invested in, or committed to, transactions in which Sinclair and his bankers, Blair & Co., Inc., were vitally and directly interested.<sup>334</sup>

During the same period in which the investors who purchased Petroleum Corporation's stock suffered a loss of \$54,000,000, Sinclair, Blair & Co., and their associates and distributors realized tangible cash benefits in excess of \$18,000,000. These cash benefits are summarized in the following table:

Excess of selling price of Prairie stocks over cost to Syndicate--	\$6,517,910
Underwriting fees received by Blair & Co. and shared with associates and distributors-----	<sup>a</sup> 9,750,000
Cash actually received for payment of option warrants-----	571,425
Excess over market received by Sinclair Consolidated Oil Corporation in sale of Prairie stocks to Petroleum Corporation-----	750,000
Profit received by Blair & Co. from sale of Petroleum Corporation's stock to Sinclair Consolidated Oil Corporation in connection with the above transaction-----	224,587
Fee received by Blair & Co. in connection with Prairie-Sinclair consolidation (less \$90,000 paid over to Petroleum Corporation)--	610,000
Fees paid to Blair & Co., Inc., and Bancamerica-Blair Corporation for research, selection, and supervision of investments <sup>b</sup> -----	55,000
Total-----	<sup>c</sup> \$18,478,922

<sup>a</sup> Allowance should be made in connection with this item for the \$606,650 sacrificed to Blair & Company's preferred list and the commissions which were lost by the Banking Group in seeking to stabilize the market.

<sup>b</sup> In 1929 Petroleum Corporation paid \$35,000 and in 1930, \$20,000 to Blair & Co., and Bancamerica-Blair Corporation. (Reply to the Commission's questionnaire for Petroleum Corporation of America, Exhibit A, Schedule 20-A, and supplementary information supplied to the Commission for Petroleum Corporation of America.)

<sup>c</sup> Not included in the cash benefits enumerated above are such items as the \$1,000,000 loss which Sinclair Consolidated Oil Corporation avoided by its sale to Petroleum Corporation of the Vacuum Oil stock; the \$148,862 paid during the period as fees to directors and members of the executive committee; the salaries to officers totaling \$241,335 for the period; and the brokerage fees paid to firms with which members of the sponsoring group were affiliated. In the year 1935 alone brokerage fees were paid to groups in which directors of Petroleum Corporation were members, as follows:

Kuhn, Loeb & Co. (Elisha Walker, partner)-----	\$14,731
Hayden, Stone & Co. (Charles Hayden, partner)-----	2,719
E. F. Hutton & Co. (Ruloff Cutten, partner)-----	2,672

(Reply to the Commission's questionnaire for Petroleum Corporation of America, Item 60, Table b.)

<sup>333</sup> It will be recalled that Sinclair's name appeared nowhere on the offering circular, nor on the long list of directors, but instead the offering circular stated with respect to the Prairie stock that "These companies are of the so-called Standard Oil Group." Elisha Walker, in testimony quoted supra, stated that the Sinclair Consolidated Oil Corporation was a comparatively new institution, without the background of more seasoned stocks like the Standard Oil stocks and presumably without attraction to the investing public. When the Sinclair Consolidated Oil Corporation in October 1928 wished to market 1,130,000 shares of its own stock, Mr. Walker claimed that almost the only way in which this stock could be gotten into the hands of the public was through the medium of the market operations conducted by Arthur W. Cutten on behalf of the Sinclair syndicate.

<sup>334</sup> These investments and commitments were as follows:

Prairie Oil & Gas and Prairie Pipe Line stock (purchase)-----	\$64,356,596
Sinclair Consolidated Oil stock (purchase)-----	2,577,560
Mission Securities syndicate (commitment)-----	10,787,000
Rio Grande syndicate (commitment)-----	2,200,000
Rio Grande revolving credit (loan)-----	1,250,000
Tidewater Associated Oil stock (purchase)-----	2,938,870
Vacuum Oil stock (purchase)-----	4,406,000

\$88,516,026



Substantial as was his share of the enumerated monetary benefits, Harry F. Sinclair secured for himself and his company advantages which doubtless transcended in importance and duration those which expressed themselves in simple terms of immediate money gain. For him there were the comprehensive advantages inherent in control of Petroleum Corporation of America by Consolidated Oil Corporation.

Curiously, the benefits to the sponsors of Petroleum Corporation of America seem invariably to have coincided with losses to the corporation and its body of public stockholders. Not a single instance can be ascertained among all Petroleum Corporation's investments and transactions ascribable to the sponsor group, which redounded in any way to the pecuniary advantage of the corporation. Without exception, every transaction from which the sponsors profited in one form or another resulted in a loss to the corporation.

It is significant that all of these transactions were strongly tinged with self-dealing on the part of the sponsors. While occupying positions of trust and confidence in relation to the stockholders, executive officers and directors of Petroleum Corporation of America undertook to represent the corporation as its faithful agents in transactions in which they were themselves personally interested as principals, adversely to the corporation.

Elisha Walker, who for three years was chairman of Petroleum Corporation's board of directors and that of its sponsor, Bancamerica-Blair Corporation, ventured to discuss this subject briefly at the public examination before the Commission. Speaking with relation to the purchase by Petroleum Corporation of 15,000 shares of Sinclair Consolidated Oil Corporation stock from the Sinclair Syndicate operation in which Blair & Co. was one of the principals,<sup>335</sup> Mr. Walker stated:<sup>336</sup>

A. \* \* \* I am not going to have the good faith of these directors impugned by intimating that they were bailing out for the sake of 15,000 shares, of a 1,000,000 share transaction. There is absolutely nothing to it.

Q. Well, the fact is, Mr. Walker——

A. These directors are men of honor and standing in the community, and they weren't being used for suckers.

Q. The fact is, though, that Blair and Company was interested in this pool of Sinclair Consolidated Oil Corporation.

A. Yes.

Q. And Mr. Harry F. Sinclair was interested.

A. Yes, you have recited all of that.

Q. And the fact is that at the tail end of the pool they sold to Petroleum Corporation this 15,000 shares at \$40 a share; isn't that so?

A. Yes, you have stated so.

Q. And the fact is that you were a participant in Sinclair Consolidated Oil pool.

A. Yes.

Q. And the fact is that you were one of the moving spirits in Petroleum Corporation.

A. Petroleum Corporation had a paid president and a very capable and able man, Mr. John Markham, who was paid for his work, and I was chairman of the board in an advisory capacity without compensation.

<sup>335</sup> Discussed in detail, *supra*, pp. 275-7.

<sup>336</sup> *Op. cit. supra*, note 1, at 3030-2.

Q. And the fact is that without imputing any bad faith, that you were substantially on both sides of that transaction, isn't that so?

A. I was substantially on both sides, yes.

Q. And the only thing I am interested in, is not whether it was bad faith or good faith, but is that a healthy condition to exist at any time with any person?

A. Oh, there are times when it is to the advantage of a corporation to be dealing with directors.

Q. Will you give me a single instance?

A. As long as the directors are honest and capable people.

Q. Will you give me a single instance in the entire history of Petroleum Corporation, that started with \$110,000,000, raised through securities that were sold to the public, and wound up in 1936 with \$35,000,000, that redounded to the benefit of the trust—one single transaction. Mr. Walker, in that entire period where the trust received any benefit from its association with Blair and Company?

A. I think that is an unfair question to ask me without preparation on it, but I know that I have been of value to this corporation, and I don't question it for one second, and I think that the directors will all support me in that statement.

\* \* \* \* \*

Q. \* \* \* I asked a simple question of fact. I asked in studying the relation between an investment banking house, and an investment company, what are the advantages and disadvantages. And now can you tell us any of the advantages which accrued to the trust by the virtue of its association with Bancamerica-Blair during the entire period?

A. I am not prepared to answer a general question of that type, but I know that there are advantages.

## VIII. INVESTMENT TRUSTS AND COMPANIES CONTROLLED BY DONALD P. KENYON AND ASSOCIATES

### A. Summary

In December 1935, Donald P. Kenyon, a promoter, purchased for the sum of \$2,300 a management and distribution agreement which gave him control of Alpha Shares, Inc., a restricted management type investment company with approximately \$43,000 of liquid assets. He promptly caused his own intimate associates and himself to be made directors and officers of this company. The first official act of the new management was to remove the investment restrictions so as to permit Mr. Kenyon's control to be unhampered.

By selling the marketable securities out of the portfolio of Alpha Shares, Inc., and substituting therefor the practically worthless securities of other companies controlled by him, Mr. Kenyon secured funds to purchase control of a group of investment and sponsoring companies consisting of National Associated Dealers, Inc.; Lancaster, Havens & O'Brien, Inc.; Monthly Income Shares, Inc., of New Jersey; and Monthly Income Shares, Inc., of New York, representing roughly an aggregate of about \$350,000 of assets. This second acquisition was completed in February 1936, and within a few weeks Kenyon entered into an agreement for the purchase of control of North Bergen Trust Company, a bank located in North Bergen, New Jersey, for \$50,000 plus a contribution to the surplus account, required by the banking commissioner of New Jersey, of \$39,000. Mr. Kenyon secured the money to pay for this acquisition by having George R. Grantham, an associate, borrow \$50,000 from Monthly Income Shares, Inc., of New York, a management investment company, and by having Mr. Grantham borrow \$36,000 from Monthly Income Shares, Inc., of New Jersey, a management investment company, a total of \$86,000, or nearly all the sum of \$89,000 required to complete the transaction.

Upon his acquisition of control of the bank Mr. Kenyon installed his associates as officers and directors and made substantial loans to himself, to other officers and directors and to companies controlled by himself and other officers and directors, in total amounts of about \$154,000. He also sold a large portion of the more conservative bond investments of the bank and replaced them with speculative common stocks, all of which was subsequently criticized severely by examiners of the Federal Deposit Insurance Corporation as being not only unwise and unsound banking policy and a violation of applicable banking statutes, but as having resulted in a serious impairment of the bank's capital assets.

Within a month or so of his acquisition of the North Bergen Trust Company, Mr. Kenyon commenced negotiations for the acquisition of a group of investment companies and trusts which, at that time, were sponsored and controlled by a corporation known as Universal Shares, Ltd., a holding and sponsoring company of investment trusts and investment companies. This group consisted of a series of investment companies and trusts and miscellaneous sponsoring and distributing companies having total assets of about \$14,000,000. Mr. Kenyon first purchased the interests of one Harold R. Espey for \$20,000 and the interest of one Murray R. Spies for \$40,000. As part of the consideration of the transfer from Mr. Spies, Mr. Kenyon secured a written promise from Mr. Spies not to interfere with any future program adopted by the management. Mr. Kenyon then perfected control over Universal Shares, Ltd., and its subsidiaries by negotiating for and securing the resignation of the then voting trustees who controlled Universal Shares, Ltd., and who were also the voting trustees of the stock of certain of the subsidiaries.

As soon as he was installed with his associates in the key offices of these companies, Mr. Kenyon proceeded systematically to deplete their assets for his own personal use. His first act was to have each of the monthly income shares corporations authorize an issue of Class AA preferred stock which was to take priority over the voting common stock of those two corporations, but which was in each case subordinate to the outstanding Class A preferred stock in respect to both dividends and liquidation rights. Since there were insufficient assets in the cases of both Monthly Income Shares corporations to meet the prior claims of the senior stock, which was the Class A stock, the newly created Class AA stock was in both cases without asset value and, in addition, the Class AA stock in both cases had no voting power.

Despite these facts, Mr. Kenyon represented to the board of directors of Investors Fund of America, Inc., one of the newly acquired investment companies, which board consisted of himself or his associates, that this newly acquired issue was the senior issue, and had the board adopt a resolution to buy 135,000 shares of the Class AA stock of Monthly Income Shares, Inc., of New York, and 115,000 shares of the Class AA stock of Monthly Income Shares Inc. of New Jersey, at a price of \$1 per share, or a total purchase price of \$250,000. At the same meeting, Mr. Kenyon proposed that Investors Fund of America, Inc., purchase from himself a total of 350 shares of the stock of North Bergen Trust Company for \$115 a share, or a total of \$40,250. In these proposed transactions, however, Mr. Kenyon met an obstacle in a custody agreement whereby Estate Administration, Inc., a corporation, was required to approve every purchase made for the account of Investors Funds of America, Inc. There were also other restrictions in the charter as to the type of securities that could be purchased with which the proposed purchases did not comply, and a provision that all purchases must be made through members of the New York Stock Exchange. Mr. Kenyon overcame the obstacle of the management contract by paying Estate Administration, Inc., \$20,000 to cancel all its contracts and thus release all its control over Investors Fund of America, Inc. He then appointed a personal acquaintance, one Edward E. Embree, as investment administrator and paid him \$500. Mr. Embree thereupon approved the proposed purchases. Mr. Kenyon then proposed amendments to the charter which would remove all investment restrictions. By permitting certain dealers who objected to the proposed charter amendments to surrender all the shares which they owned or represented at a stipulated asset value, Mr. Kenyon eliminated these objecting dealers.

Mr. Kenyon then commenced to deplete the assets of United Standard Oil fund of America, Inc., one of the investment companies in the Universal Shares, Ltd., group. As in the previous cases, he secured loans to himself, or corporations, or individuals controlled by him and substituted notes and other evidences of debt which were, in fact, worthless, for good assets which were sold to raise the money for his purposes.

In the period of approximately one year during which he controlled or dominated these various companies and organizations, Mr. Kenyon obtained more than \$900,000 by borrowing from these organizations without collateral or in worthless collateral; by selling them worthless securities; by charging them extremely high commissions for various services, some of which were never rendered, and other similar methods.

In the fall of 1936, after the State authorities began to investigate the Monthly Income Shares companies, and the Federal Deposit Insurance Corporation began its investigation of the North Bergen Trust Company, Mr. Kenyon and his associates ultimately relinquished control of practically all these companies and made restitution of a part of the sums taken. However, Mr. Kenyon and his associates retained a substantial part of the sums obtained from these companies.

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Donald P. Kenyon, a native of Boston, Massachusetts, had been engaged in promotional activities, principally in real estate in that city, until December 1935. At that time he went to New York City and with one Frank Bryant, a former associate, opened offices to conduct a general investment business and to act as fiscal agent for Administrative Corporation, a depositor for several fixed trusts.

In December 1935, Mr. Kenyon started a program of acquiring control of investment trusts and investment companies which ultimately involved the acquisition of control of groups of financial organizations and the use of their assets for his own purposes. Acquisition of control of these organizations was in four steps, all of which occurred within the period of six months from December 9, 1935, to June 10, 1936. Mr. Kenyon's activities began immediately after his first acquisition on December 9, 1935, and ceased, at least as far as these companies are concerned, about March 31, 1937, after the commencement of various proceedings by the Attorney General of New York and the Attorney General of New Jersey. His further activities were subsequently curtailed by separate proceedings by the Federal Deposit Insurance Corporation and the Securities and Exchange Commission.

However, during Mr. Kenyon's control over the organizations which are the principal subject of this report, covering the period of about 16 months between December 9, 1935, and March 31, 1937, he caused these organizations to suffer severe losses.

Mr. Kenyon's counsel, at the public examination by the Commission of these companies, made the following statement with respect to Mr. Kenyon's activities in connection with these companies:<sup>1</sup>

\* \* \* It is true Mr. Kenyon and his associates did various things that even we as counsel say were not proper \* \* \*. As a matter of fact, it is our contention that Mr. Kenyon not only one might say defrauded stockholders and the public in general, but he also was defrauded when he bought into these companies.

The companies and trusts involved in this report are as follows:

*Sponsoring, Holding, or Distributing Companies*

Alpha Management, Inc.  
American Composite Shares Corporation.  
Harriman Fund Management Corporation.  
Investment Trust of New York, Inc.  
Kenyon & Company, Inc.

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<sup>1</sup> Public Examination, Alpha Shares, Inc., et al., at 19408.

Kenyon & Company, Ltd. (of Canada).  
 Lancaster, Gorman & Co., Inc.  
 Lancaster, Havens & O'Brien, Inc.  
 Lancaster, Paynter & Co., Inc.  
 National Associated Dealers, Inc.  
 New York Shares Corporation.  
 Standard Oilshares, Inc.  
 Trustee Standard Shares, Incorporated.  
 United Depositor Corporation.  
 United Sponsors, Inc.  
 United Standard Oilshares Corporation.  
 Universal Shares, Ltd.

*Management Investment Companies*

Alpha Shares, Inc.  
 Harriman Investors Fund, Inc.  
 Interstate Investors, Inc.  
 Investors Fund of America, Inc.  
 Monthly Income Shares, Inc. (New Jersey).  
 Monthly Income Shares, Inc. (New York).  
 United Standard Oilfund of America, Inc.

*Fixed and Semifixed Trusts*

American Composite Trust Shares, Cumulative series.  
 Collateral Trustee Shares, Series A.  
 Trustee Standard Investment Shares, Series "C."  
 Trustee Standard Investment Shares, Series "D."  
 Trustee Standard Oilshares, Series "A."  
 Trustee Standard Oilshares, Series "B."  
 Trustee New York Bank Shares.

*Bank*

North Bergen Trust Company.

**B. Alpha Shares, Inc.**

Mr. Kenyon's first acquisition was Alpha Shares, Inc., effected on December 9, 1935. This acquisition Mr. Kenyon made by causing his agent to purchase from Alpha Distributors, Inc. all the stock in Alpha Management, Inc.,<sup>2</sup> which in turn controlled Alpha Shares, Inc., an investment company, by means of management and distribution agreements.<sup>3</sup> The consideration for the transaction was \$7,500, but because Alpha Management, Inc., owned \$5,200 of United States Government bonds which were transferred at the time of settlement to

<sup>2</sup> Id., Commission's Exhibit No. 3106.

See also Hearings in the Matter of Donald P. Kenyon, Charles R. Kenyon, Norman E. Dizer, George Grantham, Edward Embree, Harry Pasternak, Kenyon & Company, Inc., held on April 28, 1937, pursuant to order for investigation dated April 22, 1937, under Sec. 19 (b) and Sec. 20 (a) of the Securities Act of 1933, pp. 387-94.

<sup>3</sup> Hearings in the Matter of Donald P. Kenyon, Charles R. Kenyon, Norman E. Dizer, George Grantham, Edward Embree, Harry Pasternak, Kenyon & Company, Inc., held on April 28, 1937, pursuant to order for investigation dated April 22, 1937, under Sec. 19 (b) and Sec. 20 (a) of the Securities Act of 1933, pp. 387-8.

Alpha Distributors, Inc., only \$2,300 cash was actually paid by Mr. Kenyon.<sup>4</sup>

Alpha Shares, Inc. had been incorporated under the laws of Maryland in 1933 as a restricted management type, open-end investment company.<sup>5</sup> It had immediately executed a management and distribution agreement with Alpha Management, Inc., a subsidiary of its sponsor, Alpha Distributors, Inc., which served to perfect control of the company in the hands of the sponsors.<sup>6</sup> From the date of its organization to the time of Mr. Kenyon's acquisition of control of the company, 21,144 shares of the company's \$1 par common stock were sold to the public at prices ranging from \$5 to \$6.50 per share.<sup>7</sup> During the same period 14,660 shares of the stock were repurchased on demand of the holders.<sup>8</sup> The balance sheet of the corporation at December 31, 1935 showed total assets of the corporation to be \$42,723.69. These assets consisted in the main of \$28,834.97 of listed securities and \$13,306 of cash.<sup>9</sup>

Upon Mr. Kenyon's accession to control he supplanted the existing board of directors with his own nominees, his brother Charles Russell Kenyon, Norman E. Dizer, George R. Grantham, and Helene Sherman, who in turn elected themselves officers of Alpha Shares, Inc.<sup>10</sup>

# 1. REMOVAL OF RESTRICTIONS ON MANAGEMENT OF ALPHA SHARES, INC., AND SALE THERETO OF STOCK OF KENYON & COMPANY, INCORPORATED

On December 26, 1935, 17 days after Mr. Kenyon's acquisition of control of Alpha Shares, Inc., a notice of a special stockholders' meeting to be held January 27, 1936 was mailed to stockholders. At this meeting, 5,019 of the 6,152 shares issued and outstanding were recorded.<sup>11</sup> At this meeting resolutions approving a charter amendment were adopted,<sup>12</sup> the effect of which was to remove most of the restrictions on the management and to vest much broader powers in the board of directors. Immediately after the meeting but before the amendment became effective, the directors adopted a new list of corporations whose securities were eligible for the investment of the company's funds.<sup>13</sup> Included in the list were Bryant & Company, Incorporated, Kenyon & Company, Incorporated (of New York), and Kenyon & Company, Ltd. (of Canada), all personal corporations of Mr. Kenyon<sup>14</sup> which he had recently organized.

The State Tax Commission of Maryland received the amendment to the charter on February 10, 1936,<sup>15</sup> and on February 13, 1936 the board of directors of the company authorized the purchase of 80

<sup>4</sup> Id., at 396.

<sup>5</sup> Op. cit. supra, note 1, Commission's Exhibit No. 3106.

<sup>6</sup> Op. cit. supra, note 3, at 387-8.

<sup>7</sup> Id., at 400.

<sup>8</sup> Summary statement supplied the Commission for Alpha Shares, Inc.

<sup>9</sup> Ibid.

<sup>10</sup> Op. cit. supra, note 1, Commission's Exhibit No. 3093.

<sup>11</sup> Ibid.

<sup>12</sup> Ibid. and id., at 19679-80.

<sup>13</sup> Ibid.

<sup>14</sup> Ibid. and id., at 19682.

<sup>15</sup> Id., at 19683 and Commission's Exhibit No. 3107.

shares of the preferred stock of Kenyon & Company, Inc. at \$100 per share.<sup>16</sup> This company was merely the instrumentality which Mr. Kenyon used to facilitate his various transactions.<sup>17</sup> This stock was paid for by check in the amount of \$8,000 dated February 14, 1936, payable to a certain "Arnold & Co.," and endorsed by such payee to Kenyon & Company, Inc. by whom it was deposited.<sup>18</sup>

The next step in the Kenyon program was the acquisition of Monthly Income Shares, Inc. of New York, Monthly Income Shares, Inc. of New Jersey, both investment companies, National Associated Dealers, Inc., a depositor corporation for several fixed trusts, and Lancaster, Havens & O'Brien, Inc., a sponsoring and distributing company.

## 2. ACQUISITION OF MONTHLY INCOME SHARES, INC., OF NEW YORK, AND LANCASTER, HAVENS & O'BRIEN, INC.

Monthly Income Shares, Inc., of New York was an unrestricted closed-end management investment company incorporated at the instance of one Robert E. Lancaster under the laws of New York in December 1933.<sup>19</sup> Its initial authorized capital consisted of 100,000 shares of Class B voting stock of the par value of 10 cents per share, and 1,000,000 shares of Class A nonvoting stock of the par value of 25 cents per share. Upon liquidation of the company the Class A stock was entitled to receive \$1.00 per share plus  $\frac{1}{11}$  of any assets which remained after the payment of 40 cents per share to the Class B stock. The incorporators of the company, Joseph A. Pace, George Shaw, Jr., and Murray A. Cobb subsequently constituted the board of directors, and elected themselves president, vice president, and secretary-treasurer of the company, respectively.<sup>20</sup> These individuals were nominees of Mr. Lancaster. They continued to act as officers and directors of the company until they were supplanted by Mr. Kenyon's nominees, as will hereinafter appear.

Between December 18, 1933, and April 2, 1934, 20,000 shares of Class B stock were issued to Mr. Lancaster and his associates.<sup>21</sup>

Immediately upon its incorporation the company entered into an agreement with Mr. Lancaster for the sale by him of 50,000 shares of the Class A stock to the public at a price to net the company 50 cents per share. The agreement also provided that Mr. Lancaster

<sup>16</sup> Id., at 19683-4.

<sup>17</sup> Id., at 20069-70, and Commission's Exhibit No. 3121; see further discussion, *infra*, pp. 343-5.

<sup>18</sup> Id., at 19547-8, 19684, and Commission's Exhibit No. 3096.

<sup>19</sup> Id., Commission's Exhibit No. 3079 (p. 2). Robert E. Lancaster at March 1, 1939, was serving a sentence in San Quentin prison for a fraudulent securities transaction of which he had been convicted and sentenced in 1928 under the name of Martin Leach. Thus his transaction in New York under the alias of Robert E. Lancaster from 1933 to 1938 took place while he was a fugitive from justice. (Derived from supplementary information material supplied the Commission for Investors Fund of America, Inc.)

<sup>20</sup> *Moody's Manual of Investments, Banks, etc.*, 1936, p. 1884.

<sup>21</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. 3079 (p. 4); see also *People, etc., v. Monthly Income Shares, Inc., et al.*, Supreme Court of the State of New York, King's County (Consent Decree entered May 14, 1935), affidavit of Robert R. Wilson, Senior Accountant, Bureau of Securities of the New York State Department of Law, submitted in support of the bill of complaint, p. 51.

was to form a corporation to undertake the distribution of the remaining 950,000 shares of the Class A stock.<sup>22</sup>

Thereupon, on April 11, 1934, Lancaster, Havens & O'Brien, Inc. was incorporated under the laws of New York, primarily as a securities distributing company.<sup>23</sup> Its authorized capital consisted of 1,000 shares of common stock with a par value of \$5 per share and 5,000 shares of preferred stock with a par value of \$5 per share.<sup>24</sup> Two hundred shares of the common stock were issued to Robert E. Lancaster, apparently being all the voting stock issued.<sup>25</sup>

On May 26, 1934, Monthly Income Shares, Inc., of New York granted the exclusive right to distribute 500,000 shares of its Class A stock to Lancaster, Havens & O'Brien, Inc. For each 5,000 shares of this stock sold, the distributor was to receive a commission at the rate of 10% of the selling price, and in addition the right to buy 5,000 additional shares at 50 cents per share.<sup>26</sup>

It appears that only about two-thirds of the proceeds of the sale of this stock to the public by Robert E. Lancaster and by Lancaster, Havens & O'Brien, Inc. under these distribution agreements was ever remitted to the corporation.<sup>27</sup> The following table shows these transactions:

Distributor	Price	Number of shares sold	Gross proceeds	Amount received by Monthly Income Shares, Inc., of New York
R. E. Lancaster (1/1/34 to 6/1934).....	\$1.00-\$1.10	50,000	\$54,015.36	\$25,000.00
Lancaster, Havens & O'Brien (6/1934 to 2/30/36)	1.10-1.20	156,181	176,176.62	128,516.59
Total.....		206,181	230,191.98	153,516.59

The charter of Monthly Income Shares, Inc., of New York contained restrictions against loans to officers, directors, and holders of the Class B stock of the corporation; required at least 50% of the company's assets to consist of cash, United States Government bonds, and/or securities listed on the New York Stock Exchange or New York Curb Exchange; limited the investment in any one corporation to an amount equal to 25% of the investment company's assets; and provided that dividends might be paid only out of net profits or earned surplus.<sup>28</sup>

The offering of the stock was limited to residents of the State of New York and was at prices ranging from \$1.10 to \$1.20 per share.<sup>29</sup>

<sup>22</sup> *People, etc., v. Monthly Income Shares, Inc., et al.*, Supreme Court of the State of New York, King's County (Consent Decree entered May 14, 1935), affidavit of Robert R. Wilson, Senior Accountant, Bureau of Securities of the New York State Department of Law, submitted in support of the bill of complaint, p. 52. (Derived from supplementary information supplied the Commission for Investors Fund of America, Inc.)

<sup>23</sup> *Ibid.*

<sup>24</sup> *Ibid.*; see also *op. cit. supra*, note 3, at 812, and Commission's Exhibit No. 160 thereto.

<sup>25</sup> *Op. cit. supra*, note 22, at 52.

<sup>26</sup> *Ibid.*

<sup>27</sup> As disclosed by an examination by the office of the Attorney General of New York. (*Ibid.*)

<sup>28</sup> *Id.*, bill of complaint, Exhibit A (p. 19).

<sup>29</sup> *Ibid.* and *op. cit. supra*, note 1, Commission's Exhibit No. 3079 (p. 3).



By confining the offering to one state, Lancaster avoided the necessity of registration under the Securities Act of 1933.

The distributors offered the stock by means of a prospectus, emphasizing the charter restrictions set out above and in addition stating that the corporation would pay dividends of 1 cent per month on each share of stock out of earned surplus.<sup>30</sup> It is to be noted that in order to pay 1 cent per month on the stock the corporation would have to show net earnings of 16% per annum on the proceeds of the sale of stock, because of the large commissions retained by the distributor.

During the period from April 1934 to April 1935, Monthly Income Shares, Inc., of New York frequently lacked sufficient earnings to pay the monthly dividends. The dividends were, nevertheless, paid out of capital and this fact was concealed by making bookkeeping entries in connection with the sale of certain oil royalties by Lancaster, Havens & O'Brien, Inc. and Mr. Lancaster personally, so as to make it appear that Monthly Income Shares, Inc. had realized a profit on the sale of securities.<sup>31</sup>

On May 13, 1935, Lancaster, Havens & O'Brien, Inc., consented to the entry of a decree by the Supreme Court of the State of New York enjoining them from continuing the practices set out above.<sup>32</sup>

### 3. MONTHLY INCOME SHARES, INC., OF NEW JERSEY

On May 31, 1934, a little over a month after Lancaster, Havens & O'Brien, Inc., was organized, Monthly Income Shares, Inc., of New Jersey was incorporated under the laws of New Jersey.<sup>33</sup> Its corporate structure and management and distribution agreements with Lancaster and Lancaster, Havens & O'Brien, Inc., were identical with those of Monthly Income Shares, Inc., of New York.<sup>34</sup> Sale of this corporation's securities was to be restricted to residents of the State of New Jersey, and, as in the case of the New York corporation, registration under the Securities Act of 1933 was thereby avoided.

Ten thousand shares of the voting Class B stock of the company were issued to Mr. Lancaster, instead of 20,000 as in the case of Monthly Income Shares, Inc., of New York.<sup>35</sup>

### 4. NATIONAL ASSOCIATED DEALERS, INC.

In October 1934, Lancaster, Havens & O'Brien, Inc. acquired all the outstanding stock of National Associated Dealers, Inc., from White, Hodge & Company, investment dealers.<sup>36</sup> This stock consisted of 180 shares of common stock having a par value of \$100 per share. National Associated Dealers, Inc., was at that time the depositor under a trust agreement creating a fixed trust, Trusteed New York Bank Shares.<sup>37</sup>

<sup>30</sup> Op. cit. supra, note 22, Bill of Complaint, Exhibits A and B.

<sup>31</sup> Id., at 54-6.

<sup>32</sup> Id., affidavit of John R. O'Hanlon, Assistant Attorney General of the State of New York, pp. 35-6.

<sup>33</sup> Op. cit. supra, note 1, Commission's Exhibits Nos. 3081 and 3079 (p. 2).

<sup>34</sup> Ibid.

<sup>35</sup> Id., at 19477.

<sup>36</sup> Id., at 19697-8.

<sup>37</sup> Id., at 19697-8.

Immediately upon completion of the acquisition, Mr. Lancaster caused the authorized capitalization of National Associated Dealers, Inc., to be changed to provide for the issuance of 100,000 shares of preferred stock of a par value of 25 cents per share, and 100,000 shares of common stock with a par value of 25¢ per share. The preferred stock was to have a priority upon liquidation up to \$1.60 per share.<sup>38</sup> Lancaster, Havens & O'Brien, Inc. exchanged their 180 shares of the original stock for 8,000 shares of the new common and 8,000 shares of the new preferred stock.<sup>39</sup> An agreement was immediately executed whereby Lancaster, Havens & O'Brien, Inc. was to have exclusive distribution rights for the preferred stock of National Associated Dealers, Inc. and to receive a commission of 20% on all gross sales.<sup>40</sup> Between January 1935 and February 1936, a total of 29,163 shares of this stock was sold under the agreement to the public at approximately \$1.50 per share.<sup>41</sup>

On February 14, 1936, Donald P. Kenyon purchased from Robert E. Lancaster and his nominees all the voting stock outstanding of Monthly Income Shares, Inc., of New York, Monthly Income Shares, Inc., of New Jersey, National Associated Dealers, Inc., and Lancaster, Havens & O'Brien, Inc., for \$60,000.<sup>42</sup> By the terms of the contract of sale, \$10,000 was paid on February 14, 1936, and \$30,000 on February 19, upon completion of the transaction.<sup>43</sup> Mr. Kenyon's notes, due in 30 and 60 days, in the amount of \$10,000 each, were given to complete the payment.<sup>44</sup>

On February 20, 1936 Donald P. Kenyon caused himself, his brother, Charles Russell Kenyon, and Norman E. Dizer, one of his associates, to be elected officers and directors of these four corporations.<sup>45</sup>

#### 5. SALE OF STOCK OF MONTHLY INCOME SHARES, INC. OF NEW JERSEY TO ALPHA SHARES, INC.

On February 19, 1936 five days after Mr. Kenyon acquired control of Monthly Income Shares, Inc., of New Jersey, and nine days after the effective date of the amendment to the charter of Alpha Shares, Inc. removing the investment restrictions and giving the company's directors exclusive authority over investments, Mr. Kenyon caused Alpha Shares, Inc. to purchase from himself 5,000 shares of the Class B stock of Monthly Income Shares, Inc., of New Jersey for \$5,000.<sup>46</sup>

This stock was worthless in terms of asset value at the time because its issuer did not have enough assets to meet the prior claims of the preferred stock.<sup>47</sup>

<sup>38</sup> Id., Commission's Exhibit No. 3114.

<sup>39</sup> Op. cit. supra, note 22, at 59.

<sup>40</sup> Ibid.

<sup>41</sup> Ibid. and op. cit. supra, note 3, at 776, and Commission's Exhibit No. 153.

<sup>42</sup> Op. cit. supra, note 1, Commission's Exhibits Nos. 3079 (p. 7) and 3149.

<sup>43</sup> Ibid.

<sup>44</sup> Ibid.

<sup>45</sup> Id., at 19479.

<sup>46</sup> Id., at 19687.

<sup>47</sup> Louis J. Carr, the accountant for the company, testified at the Public Examination on Alpha Shares, Inc. (id., at 19689), that the stock had a maximum book value as of the date of sale of "three to five cents" a share. Later (id., at 19690) Mr. Carr stated that he wanted to change his testimony on this point; that the Class B stock (of the New Jersey corporation) had no book value whatsoever.

## 6. SALE OF STOCK OF MONTHLY INCOME SHARES OF NEW YORK TO ALPHA SHARES, INC.

On February 26, 1936, seven days after the foregoing transaction, and twelve days after Mr. Kenyon's acquisition of Monthly Income Shares, Inc. of New York, Mr. Kenyon caused Alpha Shares, Inc., to purchase from him 3,000 of his shares of the Class B stock of Monthly Income Shares, Inc., of New York, for \$1.50 per share, or a total of \$4,500.<sup>48</sup> This stock, like the Class B stock of its New Jersey counterpart, was without asset value at the time.<sup>49</sup>

## 7. SALE OF STOCK OF NATIONAL ASSOCIATED DEALERS, INC., TO ALPHA SHARES, INC.

On March 5, 1936, within three weeks after Mr. Kenyon's accession to control of National Associated Dealers, Inc., he sold 1,000 shares of his personal holdings of 8,000 shares of the common stock in National Associated Dealers, Inc. to Alpha Shares, Inc. at \$2.50 per share, or a total price of \$2,500.<sup>50</sup> At the time of the sale this stock was without asset value and no dividends had ever been paid on it.<sup>51</sup> On March 10, 1936, one week later, and again, a short time thereafter, Mr. Kenyon repeated this transaction, each time selling Alpha Shares, Inc., 1,000 shares of his personal holdings in National Associated Dealers, Inc., for \$2.50 per share,<sup>52</sup> and each time the stock was without asset value.<sup>53</sup> Thus, by three successive transactions Mr. Kenyon sold to Alpha Shares, Inc., 3,000 shares of the asset valueless common stock of National Associated Dealers, Inc. for a total price of \$7,500.

## 8. SALE OF STOCK OF KENYON & COMPANY, INCORPORATED TO ALPHA SHARES, INC.

On or about April 1, 1936, within two months after he secured control of Alpha Shares, Inc., Mr. Kenyon caused Alpha Shares, Inc. to purchase an additional 10 shares of the preferred stock of Kenyon & Company, Incorporated (of New York), one of his personal corporations, at \$100 per share, or a total of \$1,000.<sup>54</sup>

## 9. RÉSUMÉ OF SALES TO ALPHA SHARES, INC.

Thus, within a period of five months after Mr. Kenyon acquired control of Alpha Shares, Inc., he had caused that corporation to purchase from him, for an aggregate of \$26,000, seven blocks of stock in companies promoted by him—stocks which had no asset value at the

<sup>48</sup> Op. cit. supra, note 1, at 19690-1 and Commission's Exhibit No. 3111.

<sup>49</sup> Id., at 20060.

<sup>50</sup> Id., at 19691-2 and Commission's Exhibit No. 3112.

<sup>51</sup> Id., at 19695-8.

<sup>52</sup> Id., at 19693-4 and Commission's Exhibit No. 3113.

<sup>53</sup> Id., at 19695-6.

<sup>54</sup> Id., at 19694. Kenyon & Company, Incorporated was the principal instrument through which Donald P. Kenyon conducted his activities during this period. Monies paid in to this corporation were in most cases paid out immediately to Mr. Kenyon. For this reason it was characterized by Mr. Dizer as Mr. Kenyon's "conduit". (Id., at 19738.) The corporation did not even have a set of books until 1936, when a set of books was written up to comply with a subpoena duces tecum. (Id., at 20068.) See discussion infra, p. 344.

time Alpha Shares, Inc. purchased them and which had no asset value at any time thereafter.

When Mr. Kenyon secured control of Alpha Shares, Inc. on December 10, 1935 its total assets, consisting of cash and listed securities at market value, aggregated \$42,723. By June 30, 1936 a balance sheet of Alpha Shares, Inc.,<sup>55</sup> showed total assets of the company at \$27,223, consisting of about \$1,200 cash and the seven blocks of stock in affiliates carried on a cost basis of \$26,000. A note to the balance sheet stated that market values of these securities were not available.<sup>56</sup>

During this period, stockholders of Alpha Shares, Inc. who surrendered their shares for redemption under the open-end provision of the charter were paid amounts averaging \$7.40 per share, and over 2,600 shares were liquidated at approximately this price.<sup>57</sup> On the basis of balance-sheet values the asset value of the stock of Alpha Shares, Inc., was \$6.27 at the time of Mr. Kenyon's accession to control in December 1935 and \$6.77 at the end of June 1936. However, the latter figure is based on the cost value of \$26,000 of the stock acquired from affiliates. Since this stock had neither asset nor market value the actual realizable asset value at June 30, 1936 of the Alpha Shares, Inc. stock was six cents, a decline of \$6.71 per share, or over 99%.

## 10. SALE OF STOCK OF MONTHLY INCOME SHARES COMPANIES

On February 24, 1936, ten days after Mr. Kenyon acquired control of the Monthly Income Shares group, Mr. Lancaster organized Lancaster, Gorman & Company, Inc. under the laws of New Jersey and Lancaster, Paynter & Company, Inc. under the laws of New York. These two corporations were to act as distributors of the Class A stock of the Monthly Income Shares companies in the States of New Jersey and New York respectively.<sup>58</sup> These distributing companies received exclusive distribution rights and were to receive a commission of 22½% on the gross proceeds of all sales of the stock.<sup>59</sup>

As of February 29, 1936, the liquidating value of the Class A stock of Monthly Income Shares, Inc., of New York was 77 cents per share. There were 206,185 shares outstanding, and the net assets of the corporation amounted to \$158,267.<sup>60</sup> The net assets of Monthly Income Shares, Inc. of New Jersey, as of February 29, 1936, were \$85,017.44, and there were 88,517 shares of the Class A stock outstanding which thus had a net liquidating value per share of 96 cents.<sup>61</sup>

From February 24, 1936, to July 31, 1936, a total of 710 shares of Class A stock of Monthly Income Shares, Inc., of New York were sold by Lancaster, Paynter & Company, Inc. to the residents of New York at prices ranging from \$1.10 to \$1.20 per share: while during the

<sup>55</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. 3125.

<sup>56</sup> *Ibid.*

<sup>57</sup> *Op. cit. supra*, note 3, p. 411.

<sup>58</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. 3079 (pp. 10-11).

<sup>59</sup> *Id.*, Commission's Exhibit No. 3079 (p. 13).

<sup>60</sup> *Id.*, Commission's Exhibit No. 3083.

<sup>61</sup> *Op. cit. supra*, note 3, at 229-30 and Commission's Exhibits Nos. 72-5.

same period a total of about 1,154 shares of the Class A stock of Monthly Income Shares, Inc., of New Jersey were sold to residents of New Jersey at similar prices.<sup>62</sup> Under the terms of the distribution agreements only 77½ cents of every dollar paid by the public for this stock went to these corporations.

On February 25, 1936, the day after the execution of the distribution agreements, the two distributing companies submitted to Mr. Kenyon drafts of prospectuses to be used in connection with the sale of the Class A stock of the two Monthly Income Shares companies.<sup>63</sup> These prospectuses, approved on February 27 by Mr. Kenyon, contained representations that the charters of these companies provided (1) that no loans could be made by the corporations to any of their officers, directors, or Class B stockholders; (2) that at least 50% of the corporation's assets must consist of cash, United States Government and/or listed securities; (3) that not more than 25% of the assets of either of the corporations could be invested in the securities of any one corporation; and (4) that all dividends of the corporations were required to be paid out of earned surplus only.<sup>64</sup>

Despite the fact that Donald P. Kenyon had approved these representations, he began almost immediately upon obtaining control of these corporations to circumvent these charter restrictions by having Kenyon & Company, Inc., his dummy corporation, borrow various sums of money from the Monthly Income Shares companies. In order to increase the cash position of these companies and thus increase the amount of cash funds which he could borrow, Mr. Kenyon caused Monthly Income Shares, Inc., of New York to pledge practically its whole portfolio as collateral for loans from the Lawyers Trust Company of New York, and from Maloney, Anderson & Block, a brokerage firm. The total amount borrowed from the bank and the brokerage firm was \$109,700. The securities pledged with the Lawyers Trust Company were valued, on a cost basis, at \$145,391.88, and with Maloney, Anderson & Block, on the same basis, at \$12,267.50, or a total of \$157,659.38.<sup>65</sup> All this money was immediately lent ostensibly to George R. Grantham and Kenyon & Company, Inc., but actually to Mr. Kenyon to whom the bulk of this money was paid shortly after its receipt by the ostensible borrowers.<sup>66</sup> Mr. Kenyon effected similar transactions with Monthly Income Shares, Inc., of New Jersey.

Since March 1936 Monthly Income Shares, Inc., of New York has never had any earned surplus.<sup>67</sup> Since April 1936 Monthly Income Shares, Inc., of New Jersey, has never had any earned surplus.<sup>68</sup> Despite the charter restrictions and the representations in the selling literature with respect to payment of dividends except from earned surplus, Donald P. Kenyon, Charles Russell Kenyon, and Norman E. Dizer caused each company to pay monthly dividends of 1 cent per share on the Class A stock of each company out of the paid-in surplus

<sup>62</sup> Op. cit. supra, note 1, Commission's Exhibit No. 3079 (pp. 13-14) and Commission's Exhibit No. 3121 (pp. 759-60).

<sup>63</sup> Id., Commission's Exhibit No. 3079 (p. 11 et seq. and Exhibits thereto).

<sup>64</sup> Id., at 19957 and Commission's Exhibits Nos. 3154 and 3155.

<sup>65</sup> Id., Commission's Exhibit No. 3087.

<sup>66</sup> Id., at 19601-2 and 19738.

<sup>67</sup> Op. cit. supra, note 3, at 277-8.

<sup>68</sup> Op. cit. supra, note 1, Commission's Exhibits Nos. 3157-8 and op. cit. supra, note 3, at 256-7.

or capital; up to and including August 29, 1936, in the case of Monthly Income Shares, Inc., of New York; and up to July 27, 1936 in the case of Monthly Income Shares, Inc., of New Jersey.<sup>69</sup> It will be recalled that during April, May, June, and July of this year, Lancaster, Gorman & Company, Inc. and Lancaster, Paynter & Company, Inc., were selling the Class A stock of both these investment companies on the representation that such dividends were being paid out of earned surplus pursuant to the charter provisions.

Despite the representation as to the respective charter requirements that at least 50% of the companies' assets must consist of cash and government or listed securities, the bulk of the assets of the companies, from February 28, 1936, until September 1936, consisted of accounts or notes receivable from Mr. Kenyon, his associates, or corporations that he controlled. As of June 30, 1936 Monthly Income Shares, Inc., of New Jersey had total assets of \$171,553, of which \$122,225 represented amounts due from Kenyon & Company, Inc., \$2,500 due from Grantham and Winans, \$4,200 due from National Associated Dealers, Inc., and \$9,973 due from Lancaster, Havens & O'Brien, Inc., a total of \$138,898 due from corporations or individuals dominated by Mr. Kenyon.<sup>70</sup> The total of listed securities and cash constituted less than 19% of this company's assets at June 30, 1936, instead of 50% as required by the charter. As of July 31, 1936 Monthly Income Shares, Inc., of New York had total assets of \$225,836.09. Of this total \$187,616.83 was represented by notes and accounts receivable from companies and individuals dominated by Mr. Kenyon, and only \$31,337.64, or less than 14%, consisted of listed securities or cash, instead of 50% as required by the charter.<sup>71</sup> This condition prevailed generally from May 31, 1936, until September 1936 when pressure of the investigations caused Mr. Kenyon to restore the portfolios to their required condition.<sup>72</sup>

Similarly, in violation of the charter provisions of both investment companies prohibiting investments in any one corporation in excess of 25% of the total assets of the investment companies, Mr. Kenyon and his dummy corporations were indebted to each of the Monthly Income Shares corporations at all times between February 29, 1936 (about two weeks after his acquisition of the corporations) and November 20 of the same year, in amounts equal to or exceeding 25% of the assets of these investment companies respectively. For example, as has been indicated, as of June 30, 1936 Kenyon & Company, Incorporated, owed Monthly Income Shares, Inc., of New York the sum of \$111,028.75, which was 49.16% of the corporation's assets at that date,<sup>73</sup> and as at July 31, 1936 Kenyon & Company, Inc. owed Monthly Income Shares, Inc., of New Jersey the sum of \$122,225, or 71.25% of that corporation's assets as of the same date.<sup>74</sup>

### C. North Bergen Trust Company

The third acquisition by Donald P. Kenyon was the control of the North Bergen Trust Company, a bank and trust company organized

<sup>69</sup> Op. cit. supra, note 1, at 19507-8 and op. cit. supra, note 3, at 256-77.

<sup>70</sup> Op. cit. supra, note 1, Commission's Exhibit No. 3083.

<sup>71</sup> Id., Commission's Exhibit No. 3162.

<sup>72</sup> Id., at 20063-5.

<sup>73</sup> Id., Commission's Exhibit No. 3162.

<sup>74</sup> Id., Commission's Exhibit No. 3083.

in 1926 and located in North Bergen, Hudson County, New Jersey.<sup>75</sup> In October 1932, the North Bergen Trust Company had fallen into difficulties, and 28 banks in Hudson County, New Jersey, had jointly contributed the sum of \$120,000 to the North Bergen Trust Company to enable it to meet its obligations.<sup>76</sup> In consideration of this contribution, the contributing banks received from the trust company's stockholders 1,133 shares of its 1,500 shares of stock outstanding.<sup>77</sup> On January 1, 1934, the bank received a charter evidencing membership in the Federal Deposit Insurance Corporation.

As of February 3, 1936 the assets of the trust company were \$18,430.06, or a net book value of \$12.30 per share of stock.<sup>78</sup> In March 1936 the banks holding the 1,133 shares of stock in the trust company agreed to sell this block to George R. Grantham, agent for Donald P. Kenyon, for \$50,000,<sup>79</sup> or about \$44.13 per share.

At the same time, the New Jersey Banking Commissioner required Mr. Kenyon to donate \$39,000 to the surplus account of the bank in order to adjust the book value of the stock closer to its market value.<sup>80</sup>

On March 24, 1936 Mr. Kenyon caused Monthly Income Shares, Inc., of New York to lend \$50,000 to Mr. Grantham, and Monthly Income Shares, Inc., of New Jersey to lend \$36,000 to Kenyon & Company, Incorporated, to meet his obligations in connection with the purchase of the bank stock. Norman E. Dizer admitted knowing that the funds were to be used for this purpose.<sup>81</sup>

Q. Mr. Dizer, did you know at the time that Monthly Income Shares, Inc., of New York, extended a loan to George Grantham that that was going to be used for this purpose?

A. Yes.

Q. You knew that the \$50,000 was going to be applied to the purchase of 1,133 shares of stock of North Bergen Trust Company?

A. I believe I did.

Mr. Dizer further testified:<sup>82</sup>

Q. Did you know, Mr. Dizer, at the time Monthly Income Shares, Inc., of New Jersey, extended the loan of \$36,000 to Kenyon and Company in March of 1936 that that money was going to be applied as a donation to the surplus of the North Bergen Trust Company as required by the bank commissioner?

A. Yes.

The \$50,000 lent Mr. Grantham was paid to the banks for the 1,133 shares of trust company stock, and the \$36,000 lent to Kenyon & Company, Incorporated plus an additional \$3,000, was paid into the trust company's surplus account pursuant to the Banking Commissioner's direction.<sup>83</sup>

<sup>75</sup> Id., Commission's Exhibit No. 3101.

<sup>76</sup> Id., at 19584.

<sup>77</sup> Ibid.

<sup>78</sup> Id., at 19585-6.

<sup>79</sup> Id., at 19587, 19591.

<sup>80</sup> Id., at 19590-1.

<sup>81</sup> Id., at 19587-8.

<sup>82</sup> Id., at 19591.

<sup>83</sup> Id., at 19587-8, 19591.

## 1. LOANS BY NORTH BERGEN TRUST COMPANY

Mr. Kenyon acquired control of the North Bergen Trust Company on March 24, 1936. Within one week Mr. Kenyon had put Messrs. Dizer, Thayer, Grantham, and himself on the board of directors of the company, and thus dominated the board. On March 28, 1936, Kenyon put through a resolution of the executive committee of the board authorizing the following loans:<sup>84</sup>

National Associated Dealers, Inc.....	\$20,000
Lancaster, Havens & O'Brien, Inc.....	20,000
Kenyon & Company, Incorporated.....	20,000
Weil Management Company <sup>85</sup> .....	15,000
Donald P. Kenyon.....	20,000
Charles Russell Kenyon.....	15,000
Monthly Income Shares, Inc. (N. Y.).....	20,000
Monthly Income Shares, Inc. (N. J.).....	20,000
Total.....	150,000

The resolution did not require that the loans be secured. These loans were stated by examiners for the Federal Deposit Insurance Corporation to be in violation of the New Jersey banking laws, in that they were loans in which directors had an interest.<sup>86</sup> Of the loans which the board authorized to be made to Mr. Kenyon and his associates, the following loans were actually made:

Apr. 30, 1936. Kenyon & Company, Inc.....	\$15,000.00
Apr. 30, 1936. National Associated Dealers, Inc.....	15,000.00
Apr. 30, 1936. Lancaster, Havens & O'Brien, Inc.....	15,000.00
Apr. 30, 1936. Monthly Income Shares, Inc. (N. Y.).....	15,000.00
Apr. 30, 1936. Monthly Income Shares, Inc. (N. J.).....	15,000.00
Apr. 23, 1936. Weil Management Co.....	12,000.00
May 9, 1936. Weil Management Co.....	14,000.00
Aug. 3, 1936. Weil Management Co.....	5,000.00
Apr. 26, 1936. Charles Russell Kenyon.....	8,000.00
Aug. 3, 1936. Charles Russell Kenyon.....	5,000.00
Apr. 22, 1936. Donald P. Kenyon.....	5,000.00
June 22, 1936. Lancaster, Gorman & Company, Inc.....	15,000.00
Aug. 3, 1936. E. K. Schwartz.....	5,000.00
May 1, 1936. E. F. Chase.....	301.50
Aug. 13, 1936. Robert R. Livingston.....	10,000.00
Total.....	154,301.50

At the same meeting, the directors authorized the sale of \$291,000 of government, municipal, and high-grade industrial bonds and the purchase of a miscellaneous block of stocks as follows: 200 shares of

<sup>84</sup> The information contained in this discussion of loans of the North Bergen Trust Company is based largely on testimony taken in New York City before D. V. Penn, Supervising Examiner of the Federal Deposit Insurance Corporation on January 21-22, 1937, in the Matter of North Bergen Trust Company.

<sup>85</sup> Weil management Co. was a corporation with which Mr. Kenyon and his associates were identified.

<sup>86</sup> Op. cit. supra, note 84, at 35. New Jersey, P. L., 1936, Ch. 131, sec. 15, as amended June 5, 1936.



Curtiss-Wright Corporation, Class A, 200 shares of Douglas Aircraft Company, Inc., common, 100 shares of Bethlehem Steel Corporation, common, 1,200 shares of Chrysler Motors Corporation. The bonds were sold and all the stocks purchased pursuant to the resolution, except 100 shares of Chrysler Motor Corporation.

In addition to these loans, the account of Kenyon & Company, Incorporated with the North Bergen Trust Company showed an overdraft of \$5,500 from June 15, 1936, to September 18, 1936; the account of Monthly Income Shares, Inc., of New Jersey showed an overdraft of \$5,000 from July 3 to July 6, 1936; and the account of Monthly Income Shares, Inc., of New York showed an overdraft of \$4,000 from July 8 to July 9, 1936.

The report of an examination of the bank by the Federal Deposit Insurance Corporation examiners in the latter part of September 1936 indicated a capital impairment of about \$113,000 as a result of these practices. No information is available to indicate the amount which was repaid on these loans. The important element in connection with this report on Mr. Kenyon's activities is the fact that he used a substantial part of \$169,000 of funds obtained from the bank to facilitate his activities in connection with the various companies that he controlled.<sup>87</sup>

#### **D. Universal Shares, Ltd., United Sponsors, Inc., et al.**

The fourth group of acquisitions by Mr. Kenyon consisted of the following investment and sponsoring companies and fixed investment trusts:

(a) Universal Shares, Ltd., a sponsor-holding company which owned or controlled: Trustee Standard Shares, Inc., depositor for fixed trusts known as Trustee Standard Investment Shares, Series C, and Trustee Standard Investment Shares, Series D; Standard Oil Shares, Inc., depositor for fixed trusts known as Trustee Standard Oilshares, Series A, and Trustee Standard Oilshares, Series B; American Composite Shares Corporation, depositor for American Composite Trust Shares, Cumulative Series, a fixed trust; and Investment Trust of New York, Inc., depositor for Collateral Trustee Shares, Series A, a fixed trust;

(b) United Sponsors, Inc. (formerly Corporate Securities, Inc.), a sponsor-holding company for Investors Fund of America, Inc. (formerly Corporate Securities Fund, Inc., an investment company);

(c) United Standard Oilshares Corporation, a sponsor-holding company for United Standard Oilfund of America, Inc., an investment company;

(d) Harriman Investors Fund, Inc.; and

(e) Interstate Investors, Inc., management investment companies.

Universal Shares, Ltd., was incorporated in 1933 under the laws of Delaware for the purpose of owning, controlling, and sponsoring various investment trusts and companies, primarily the fixed investment trust type.<sup>88</sup> The organizers of this company were Harold Espey and his associates. Shortly after the organization of the com-

<sup>87</sup> On April 19, 1937, control of the bank passed to a group of residents of North Bergen (Op. cit. supra, note 84; see also op. cit. supra, note 1, at 19592-3.)

<sup>88</sup> Op. cit. supra, note 1, at 19436-7.

pany, Lucian A. Eddy, who had been a vice president of the Equitable Trust Company of New York, became an officer and director of the company.<sup>89</sup>

At about this time Corporate Equities, Inc., a holding company organized Corporate Securities, Inc., a distributing company.<sup>90</sup> All the stock of Corporate Securities, Inc. was issued to Corporate Equities, Inc. or its nominees. Corporate Securities, Inc., received the contract to distribute the shares of and manage Corporate Securities Fund, Inc., an open-end restricted management investment company, which had also been organized by the same predecessor sponsor group. Under these agreements, Corporate Securities, Inc. received a management fee equal to  $\frac{1}{2}$  of 1% on the daily average value of the fund, and a distribution commission of  $9\frac{1}{4}\%$  of the asset value of the shares sold.<sup>91</sup>

The investments of Corporate Securities Fund, Inc., the investment company, were to be limited to listed securities, government bonds and securities of banks and investment companies whose portfolios were composed of listed, government, or bank securities. Not more than 5% of the company's assets were to be invested in securities of any one issuer. The authorized capital of the company consisted of 20,000,000 shares of stock of the par value of 25 cents per share.<sup>92</sup> The First National Bank of Jersey City became trustee and depository for the property of the company immediately upon the organization of the latter.<sup>93</sup>

In November 1933, all the stock of Universal Shares, Ltd. was placed in a voting trust with Messrs. Spies, Eddy, and one John F. O'Ryan as the voting trustees.<sup>94</sup> On May 2, 1934, Universal Shares, Ltd. acquired all the common stock of Corporate Securities, Inc., the distributing company, from Corporate Equities, Inc. for \$25,000, in cash,<sup>95</sup> and promptly changed the name of Corporate Securities, Inc., to United Sponsors, Inc., and the name of the investment company, Corporate Securities Fund, Inc. to Investors Fund of America, Inc.<sup>96</sup>

On February 8, 1935 the same group (Messrs. Spies, Hillyer, Eddy, Espey, and O'Ryan) incorporated under the laws of Delaware another investment company, United Standard Oilfund of America, Inc. and its sponsor, manager, and distributor, United Standard Oilshares Corporation.<sup>97</sup> The investment company was identical in structure with the Investors Fund of America, Inc., formerly Corporate Securities Fund, Inc., except that its portfolio was to be limited to oil stocks. The sponsor, United Standard Oilshares Corporation was identical in structure with United Sponsors, Inc.<sup>98</sup> The stock of United Standard Oilshares Corporation was issued to Universal Shares, Ltd.<sup>99</sup> The authorized capital of the United

<sup>89</sup> Id., at 19437.

<sup>90</sup> Id., at 19434-6 and Commission's Exhibit No. 3066.

<sup>91</sup> Id., at 19437-40 and Commission's Exhibits Nos. 3067 and 3063.

<sup>92</sup> Id., at 19435-6, 19444, and Commission's Exhibit No. 3066.

<sup>93</sup> Id., at 19448-9.

<sup>94</sup> Id., at 19445.

<sup>95</sup> Id., at 19437.

<sup>96</sup> Id., at 19435-6.

<sup>97</sup> Id., at 19443-4, 20078; see also summary statement supplied the Commission for United Standard Oilfund of America, Inc.

<sup>98</sup> Op. cit. supra, note 1, at 19443-4.

<sup>99</sup> Id., at 19446, and Commission's Exhibit No. 3104.

Standard Oilfund of America, Inc. consisted of 20,000,000 shares of common stock of the par value of 25 cents per share.<sup>100</sup>

Prior to the commencement of the distribution campaign of the stock of these two investment companies, Investors Fund of America, Inc., and United Standard Oilfund of America, Inc., contracts were entered into between the two sponsoring companies, United Sponsors, Inc., and United Standard Oilshares Corporation, and Estate Administration, Inc., a corporation controlled and managed by one George F. LeBlanc and one W. L. Wirblauer, under the terms of which Estate Administration, Inc. became the investment administrator for the two investment companies with mandatory powers over their portfolios.<sup>101</sup>

In May 1934 and February 1935, respectively, Universal Shares, Ltd. caused the two sponsoring corporations, United Sponsors, Inc. and United Standard Oilshares Corporation, to authorize the issuance of debentures in the principal amounts of \$100,000 each, to be sold to the public. Both these debenture issues were to be retired out of a sinking fund which was to be created by the payment of 1% on the gross sales price of the stock of the investment companies. The indentures for these debentures, the debentures themselves, and the prospectuses used in connection with the sales of these debentures, all provided that the distribution contracts could not be assigned or canceled without the consent of the holders of the majority of the debentures outstanding. These debentures were all sold to the public by Dwelly, Pearce & Company, Inc., investment bankers, United Sponsors, Inc., and United Standard Oilshares Corporation.<sup>102</sup>

About 3,000,000 shares of the stock of Investors Fund of America, Inc. were sold to the public at prices ranging from 82 cents to \$1.20 per share from the date of its organization through June 10, 1936. On June 10, 1936, Investors Fund of America, Inc. had total assets of \$2,939,791.<sup>103</sup> About 240,000 shares of the stock of United Standard Oilfund of America, Inc. were sold during the same period at prices ranging from \$1 to \$1.50.<sup>104</sup> On June 10, 1936, United Standard Oilfund of America, Inc. had total assets of \$250,517.<sup>105</sup> Dwelly, Pearce & Company, Inc. supervised distribution of these shares until 1935, when Dwelly, Pearce & Company, Inc. terminated its connection with the distribution which was thereafter carried on actively by United Sponsors, Inc. and United Standard Oilshares Corporation, respectively.

During the period from June 1933 to June 1936, Universal Shares, Ltd. acquired control of a number of depositors of fixed investment trusts: Trustee Standard Shares, Inc., depositor for Trustee Standard Investment Shares, Series C, and Trustee Standard Investment Shares, Series D; Standard Oilshares, Inc., depositor for Trustee Standard Oilshares, Series A, and Trustee Standard Oilshares, Series B; American Composite Shares Corporation, depositor for American Compos-

<sup>100</sup> Id., at 19444; see also summary statement filed with the Commission for United Standard Oilfund of America, Inc.

<sup>101</sup> Op. cit. supra, note 1, at 19438-40, 19444-5, and Commission's Exhibit No. 3069.

<sup>102</sup> Id., at 19441-2, 19447-8, and Commission's Exhibits Nos. 3070 and 3072.

<sup>103</sup> Id., Commission's Exhibit No. 3105.

<sup>104</sup> Id., at 19446-7.

<sup>105</sup> Id., Commission's Exhibit No. 3105.

ite Trust Shares, Cumulative Series; Investment Trust of New York, Inc., depositor for Collateral Trustee Shares, Series A.<sup>106</sup> Most of these trusts had been created under the sponsorship of Dwelly, Pearce & Company, Inc.<sup>107</sup> The holders of the shares of these fixed investment trusts were solicited to exchange their shares for shares of Investors Fund of America, Inc., and United Standard Oilfund of America, Inc., the two management investment companies. Numerous holders were induced to exchange their shares.<sup>108</sup>

Toward the end of 1935 and the early part of 1936, United Sponsors, Inc. and United Standards Oilshares Corporation became short of funds, due to the burden of salaries and overwriting agreements in favor of certain of the officers and voting trustees,<sup>109</sup> and the management apparently became receptive to any arrangement which would furnish additional funds.

In May 1936 Mr. Espey, one of the original sponsoring group, sold his voting trust certificates, representing 127,500 of the 500,000 shares of outstanding stock in the controlling company, Universal Shares, Ltd. to Donald P. Kenyon for \$20,000 cash.<sup>110</sup> Mr. Espey agreed to sever his connection with Universal Shares, Ltd. and to use his best efforts to obtain the resignation of the voting trustees. Since the asset value of Mr. Espey's stock did not exceed approximately \$12,750, Mr. Espey received from Mr. Kenyon approximately \$8,000 in excess of the asset value of the shares. Mr. Espey represented to Mr. Kenyon that this block constituted control of Universal Shares, Inc. and its subsidiaries. However, Mr. Kenyon later discovered that this block did not represent control.<sup>111</sup> He thereupon, on June 10, 1936, paid the sum of \$40,000 to Murray R. Spies, who agreed to resign as a voting trustee and to secure the resignation of Lucian A. Eddy as a voting trustee. Mr. Spies resigned all offices and directorates in the various corporations and executed a release for all claims against the company for back salary, overwriting commissions and advances.<sup>112</sup> Mr. Spies paid Mr. Eddy \$2,000 for his resignation as voting trustee.<sup>113</sup> The agreement between Mr. Kenyon and Mr. Spies further provided that Mr. Spies would not interfere with Mr. Kenyon's operation of Universal Shares, Ltd. and its subsidiaries, and that Mr. Spies would not represent stockholders of any of the companies in any action against Mr. Kenyon. The agreement provided:<sup>114</sup>

\* \* \* The Party of the Second Part [Spies] hereby represents that he will not, at any time hereafter, take any steps, directly or indirectly, or perform any act, and will not in any way interfere with the Party of the First Part [Kenyon] being able to acquire any existing obligations of any of the above companies at such prices as said Party of the First Part may be able to acquire same, and that said Party of the Second Part will not in any way interfere with, directly or indirectly, with the business or affairs of any of said corporations, so long as

<sup>106</sup> Id., at 19959-60, et seq., 19436-7, and Commission's Exhibit No. 3104.

<sup>107</sup> Id., at 19967.

<sup>108</sup> Id., at 19965, 19971-2.

<sup>109</sup> Id., at 19449-50.

<sup>110</sup> Id., Commission's Exhibits Nos. 3159 and 3160.

<sup>111</sup> Id., at 19868-9, 19978.

<sup>112</sup> Id., at 19452-3, and Commission's Exhibit No. 3073.

<sup>113</sup> Id., at 19453. Mr. O'Ryan was also induced to resign by Mr. Kenyon. (Ibid.)

<sup>114</sup> Id., Commission's Exhibit No. 3073.

the Party of the First Part shall be the owner and in control thereof. (Interference as herein defined is as follows:) "to enter into or take part in the concerns of the Party of the First Part and the affiliated companies mentioned herein, especially to prevent some act taken, or contemplated by the Party of the First Part, or the affiliated companies."

\* \* \* \* \*

The Party of the Second Part [Spies] represents and agrees that he will not accept a retainer to act as the Attorney, Agent, or representative of any of the stockholders or security holders of the several corporations hereinabove named, and/or the affiliates thereunder.

Thus for a consideration Messrs. Spies and Eddy, who personally owned few if any of the shares of stock or voting-trust certificates of Universal Shares, Ltd. and its subsidiary investment companies, abdicated their position as voting trustees and turned over the management and control of these companies to Mr. Kenyon. The stockholders who were the beneficial owners of the assets of these enterprises were never consulted or even informed about the transfer of control of their companies to Mr. Kenyon prior to this transfer. In addition, Mr. Spies agreed, as soon as he formally gave up his position as a fiduciary of the stockholders, not to oppose any of Mr. Kenyon's future acts.

Shortly after June 10, 1936, the date of the payment to Mr. Spies, the constituency of the control group was entirely changed. Donald P. Kenyon, George R. Grantham, and Harry S. Thayer became officers and directors of Universal Shares, Ltd., United Sponsors, Inc., and United Standard Oilshares Corporation, and of the various other companies.<sup>115</sup> Messrs. Eddy and Keppler were the only two of the original regime who were retained. Mr. Eddy became president and general manager of Investors Fund of America, Inc. under a five-year contract which called for compensation to him of about \$15,000 per year, and a five-year contract to act in a similar capacity for United Standard Oilfund of America, Inc. for \$5,200 per year, or a total of \$20,200.<sup>116</sup> This new compensation of Mr. Eddy was substantially more than he had been receiving.<sup>117</sup>

# 1. SALE OF STOCK OF MONTHLY INCOME SHARES, INC., ETC., TO INVESTORS FUND OF AMERICA, INC.

On June 15, 1936, Donald P. Kenyon had his attorney, Samuel Sobel, amend the charters of Monthly Income Shares, Inc., of New Jersey and Monthly Income Shares, Inc., of New York, to authorize a new class of stock for each of these corporations, consisting of 500,000 shares of Class AA preferred stock for each company, of the par value of 25 cents per share.<sup>118</sup> This stock in each case was made subordinate to the outstanding Class A stock sold to the public, both as to dividend and liquidation priorities, but senior to the Class B, voting stock held by the controlling interests.<sup>119</sup> After this amend-

<sup>115</sup> Id., at 19453-4, 19455-6, and Commission's Exhibit No. 3074.

<sup>116</sup> Id., at 19453-5.

<sup>117</sup> Ibid.

<sup>118</sup> Id., at 20003, et seq., and Commission's Exhibits Nos. 3081 and 3082.

<sup>119</sup> Ibid.

ment, the authorized capital of each of Monthly Income Shares companies was as follows:

	Class A shares	Class AA shares	Class B (voting) shares
Monthly Income Shares, Inc., of New York .....	1,000,000	500,000	100,000
Monthly Income Shares, Inc., of New Jersey .....	1,000,000	500,000	100,000

On June 18, 1936, eight days after Mr. Kenyon had secured control of Investors Fund of America, Inc. and three days after the charter amendments of the Monthly Income Shares companies, Mr. Kenyon called a meeting of directors of Investors Fund of America, Inc., at which he recommended that the corporation purchase at \$1.00 per share 115,000 shares of Class AA stock of Monthly Income Shares, Inc., of New Jersey and 135,000 share of Class AA stock of Monthly Income Shares, Inc., of New York.<sup>120</sup> The directors adopted this recommendation and purchased these shares. At the meeting, Mr. Kenyon submitted two statements purporting to show that each of the Monthly Income Shares companies had portfolios composed of listed securities as of the date of the meeting.<sup>121</sup> As a matter of fact over 80% of the assets of each of these two companies consisted of notes and accounts receivable due from Kenyon & Company, Incorporated, and other individuals and corporations controlled by Donald P. Kenyon, all of which notes and accounts were unsecured.<sup>122</sup> Mr. Kenyon further represented that the Class AA stock, which he proposed that Investors Fund of America, Inc. purchase, was the senior issue of the respective companies and had priority over all the other securities of their respective issuers. Lucian A. Eddy testified that these representations were made: <sup>123</sup>

Q. Did Mr. Kenyon at the time these purchases were authorized by the Board of Investors' Fund make any representations with respect to the preference of this stock?

A. He did. He indicated to us that it was a preferred stock as called.

Q. Did he explain to you that each of the Monthly Income Shares corporations had other outstanding stock?

A. Yes; subordinate to that.

Q. But he represented that this new preferred stock was senior to the other outstanding issues?

A. That is right; he did.

Q. You say it was on the basis of Mr. Kenyon's representation relative to these three blocks of stock that the directors of Investors' Fund authorized the purchase thereof.

A. And entirely on his recommendation and representations.

As a matter of fact, the Class AA stock of both corporations were subordinate to the Class A stock and were without asset value at the

<sup>120</sup> Id., at 19457-9, 19460, and Commission's Exhibits Nos. 3075 and 3076.

<sup>121</sup> Ibid., and Commission's Exhibits Nos. 3075 (Schedule A), 3076, 3077, and 3078.

<sup>122</sup> Id., at 19480-4.

<sup>123</sup> Id., at 19461.

time of the purchases. Louis J. Carr, accountant for the companies, testified:<sup>124</sup>

Q. So that on June 30, 1936, since the outstanding Class A stock has prior rights of liquidation up to \$1.50 a share, the Class AA preferred stock at that time was worthless. Is that correct?

A. That is correct.

Q. That is on June 30, just twelve days after Investors' Fund of America paid \$135,000 for 135,000 shares of the Class AA stock?

A. That is right.

Q. Can you testify from that sheet, Mr. Carr, as to the net book value of the Class A stock of Monthly Income of New York as of May 31, 1936?

A. Sixty-two cents per share.

Q. And as of July 31, 1936?

A. \$1.06 per share.

Q. As of August 31, 1936?

A. \$1.05 per share.

Q. As of September 2, 1936?

A. \$1.06 per share.

Q. So that at no period up to September 2, 1936, did the Class AA preferred stock have any book value whatsoever?

A. That is right.

Mr. Eddy, president of Investors Fund of America, Inc., approved the purchase of the "AA" stocks of the Monthly Income Shares companies on these representations of Mr. Kenyon, without making any attempt to verify the relative priorities of the "AA" stocks and without insisting on an independent audit of the securities held by the Monthly Income Shares companies. Mr. Eddy testified.<sup>125</sup>

Q. At the time of the purchase just referred to [the North Bergen Trust Co. stock] Mr. Eddy were you taking orders from Donald P. Kenyon?

A. I wasn't supposed to be taking orders but he was running the business without consulting me.

Mr. Eddy testified further:<sup>126</sup>

Q. \* \* \* Mr. Eddy, as I understand it, the company of which you were president bought Monthly Income Shares of New Jersey stock.

A. The preferred stock.

Q. At the time the preferred stock was purchased, did they show you the schedule of securities?

A. Yes.

Q. And that is the one that was signed by Kenyon?

A. That is right.

Q. Did you know where the securities were kept, who had custody of the Monthly Income Share securities?

A. I think at that time he represented that the North Bergen Trust Company was custodian.

Q. Did you call the North Bergen Trust Company and ask them if they were there?

A. We did not.

<sup>124</sup> Id., at 19501-2.

<sup>125</sup> Id., at 19456.

<sup>126</sup> Id., at 19487-92.

Q. This schedule which purports to set forth the securities in the portfolio of Monthly Income Shares of New Jersey was not certified by an accountant, was it?

A. No.

Q. It was not certified by the bank?

A. No.

Q. It was just signed by Charles Russel Kenyon?

A. That is right.

Q. And you were president when you bought these just on his original representation that that is what they had.

A. It would appear that way \* \* \*

\* \* \* \* \*

Q. So they told you they had \$75,000 worth of securities. They gave a piece of paper signed by Mr. Kenyon and that was all right with you?

A. Yes.

Q. You didn't call the depository to see if they had them—you had no accountant go over them?

A. No.

Q. Did you call up the accountant for Monthly Income Shares and say "I have got a certificate here signed by Mr. Kenyon saying there are \$75,000 worth of blue chips here, do you know whether he has them"?

A. No; I didn't do that.

\* \* \* \* \*

Q. Mr. Eddy, before you approved of the purchase of the Monthly Income Class "AA" preferred stock, did you examine the charters of the Monthly Income Shares Corporation?

A. No.

Q. To determine its priority or inferiority in liquidation?

A. No.

Similar representations were made to the custodian for the assets of Investors Fund of America, Inc., the First National Bank of Jersey City, as to the stock proposed to be purchased.<sup>127</sup> This bank was not affiliated with Mr. Kenyon, and officers of the bank insisted that the corporation comply with the terms of the trust agreement and procure the written approval of the investment manager of the fund, Estate Administration, Inc.<sup>128</sup> Upon being approached by Mr. Kenyon's representatives for such approval the officials of Estate Administration, Inc. refused to approve the purchases because they were not convinced that the stock was what it purported to be.<sup>129</sup>

On June 20, 1936, Mr. Kenyon removed this obstacle by the payment to Estate Administration, Inc., of \$20,000 to cancel its contract with Investors Fund of America, Inc., and thereby surrender its mandatory powers over the corporation's investment policy.<sup>130</sup> Two days later, Mr. Kenyon hired one Edward Embree, an acquaintance, to act as investment administrator for a period of only 30 days.<sup>131</sup> Mr. Embree was given the mandatory powers formerly possessed by Estate Admin-

<sup>127</sup> Id., at 19563.

<sup>128</sup> Id., at 19555-9.

<sup>129</sup> Id., at 19539.

<sup>130</sup> Id., at 19659-60.

<sup>131</sup> Id., at 19510-19 and Commission's Exhibits Nos. 3088 and 3089. Mr. Embree testified that he had been an analyst, statistician, and investment counsel with various organizations since 1914. (Id., at 19510.)



istration, Inc., including the power under the custody agreement to approve portfolio purchases for Investors Fund of America, Inc.<sup>132</sup> As soon as this agreement with Mr. Embree was signed, Mr. Kenyon paid Embree \$500 in cash and handed him, for his signature, certain typewritten letters directed to the First National Bank of Jersey City, trustee, approving the proposed purchases of Class AA stock of the two Monthly Income Shares companies.<sup>133</sup> The letters were on the stationery of "Edward Embree & Company," an organization of which Mr. Embree stated he had never heard, and which never existed before or at the time Mr. Embree signed the letters. Mr. Embree testified:<sup>134</sup>

Q. Will you explain that, please? What is the origin of Edward Embree & Company?

A. Prior to Mr. Kenyon's arrival, I had never heard of Edward Embree & Company, and when Mr. Kenyon brought down Edward Embree & Company letterheads, these letterheads on which these letters were written——

Q. (Interposing.) He brought that stationery with him?

A. He did.

Q. On June 22nd?

A. That is right; and I said, "I have not formed any Edward Embree & Company." He said at that time, "Well, your wife can be a member of the company," and said, "That can be fixed up later."

Q. What did he mean by "fixed up"?

A. That is, formally registered, the name Edward Embree & Company.

Q. As a trade name or incorporated?

A. As a trade name, which I did later.

\* \* \* \* \*

Q. The name originated entirely with Donald P. Kenyon. Is that correct?

A. Yes; it is.

One more provision of the charter of Investors Fund of America, Inc.,<sup>135</sup> and the custody agreement<sup>136</sup> had to be circumvented before Mr. Kenyon could complete this transaction: all purchases and sales for the account of the corporation had to be executed by a member of the New York Stock Exchange. Neither Kenyon & Company, Inc., which ostensibly acted as the brokers for the Monthly Income Shares corporations, nor any of the Kenyon companies or individual associates were members of the New York Stock Exchange. Accordingly, the firm of Guttentstein & Lasdon, members of the New York Stock Exchange, through their partner, one Harry Pasternak, was secured as brokers in the sale of the Class AA stock of the two Monthly Income Shares corporations to Investors Fund of America, Inc. A commission or fee of \$2,500 was paid to this firm for the service.<sup>137</sup> The stock was thereupon purchased; the checks in payment therefor in the respective amounts of \$136,350 and \$116,150 were issued and

<sup>132</sup> Ibid.

<sup>133</sup> Ibid.

<sup>134</sup> Id. at 19521-2 and Commission's Exhibit No. 3090.

<sup>135</sup> Id., Commission's Exhibit No. 3066.

<sup>136</sup> Id., Commission's Exhibit No. 3097, Article II, sec. 2.05, p. 9.

<sup>137</sup> Because of provisions in the charter of Alpha Shares, Inc., requiring purchases and sales for that company's portfolio to be made through a member of the New York Stock Exchange, Mr. Kenyon had come to an understanding with Mr. Pasternak, acting for Guttentstein & Lasdon, whereby the latter would "clear" these purchases and thus comply with the charter provisions. (Id., at 19700-9.) The instant transaction was simply one of a series. (Id., at 19709-11.)

delivered to Guttentstein & Lasdon and endorsed by them to Kenyon & Company, Inc.<sup>138</sup> Although Kenyon & Company, Inc., was acting as broker for both Monthly Income Shares corporations, the money was never turned over to these corporations. The proceeds were accounted for by Kenyon & Company, Inc., by charging commissions of \$56,250, or 22½% of the selling price of the Class AA preferred stock, and setting up the balance on the books of the Monthly Income Shares corporations as accounts receivable due from Kenyon & Company, which accounts receivable were unsecured. With reference to the application of the proceeds, Mr. Dizer testified:<sup>139</sup>

Q. You were treasurer of Monthly Income Shares of New York at this time?

A. I was.

Q. Do you recall whether or not Monthly Income Shares of New York received \$135,000 in cash; that is, the proceeds of the sale of this stock from Investor's Fund of America?

A. They did not.

Q. Isn't it true, Mr. Dizer, that prior to this sale Monthly Income Shares of New York entered into a contract with Kenyon and Company, Inc., pursuant to which Kenyon and Company, Inc., was given exclusive rights to the distribution of the Class "A" preferred stock?

A. I believe there was.

Q. And also pursuant to that distribution contract, wasn't Kenyon and Company entitled to a 22½ percent commission on all sales effectuated?

A. I believe that is right; yes.

Q. So that, would you say 22½ percent of the \$135,000 went to Kenyon and Company, Inc., as their brokerage commission?

A. Yes.

Q. And the other 77½ percent, you say, was never received by Monthly Income Shares, Inc., of New York? Was it set up as an account receivable on the books of Monthly Income Shares, Inc., of New York, do you know?

A. It was.

Q. An account receivable from Kenyon and Company, is not that correct?

A. Right.

Q. Are you also familiar, Mr. Dizer, with the sale of 115,000 shares of Class "AA" preferred stock of Monthly Income Shares, Inc., of New Jersey to Investor's Fund of America as of June 26, 1936?

A. I am.

Q. And you are aware of the fact that Investor's Fund of America paid \$115,000 for that stock?

A. I am.

Q. And isn't it true that Kenyon and Company had a similar distribution contract with Monthly Income Shares, Inc., of New Jersey, pursuant to which it was entitled to exclusive rights of the distribution of the Class "A" stock and also under which it was entitled to a commission of 22½ percent upon each sale effected?

A. I believe that is right.

Q. So that Kenyon and Company received 22½ percent of \$115,000 as its brokerage commission upon this sale?

A. That is right.

<sup>138</sup> Op. cit. supra, note 1, at 19711-26, and Commission's Exhibits Nos. 3099 and 3100.

<sup>139</sup> Id., at 19608-10. These accounts were paid after the company had been thrown into receivership by the Attorneys General of New York and New Jersey, respectively. (Id., at 19611.)

Q. And the other 77½ percent, was that set up as an account receivable also upon the books of Monthly Income Shares, Inc., of New Jersey?

A. It was.

Q. As an account receivable from Kenyon and Company?

A. Right.

By this transaction Investor's Fund of America, Inc. received practically worthless preferred stock of corporations the market value of whose assets was less than 20% of their book value. After paying \$20,000 to Estate Administration, Inc. to eliminate its opposition to the purchase, and paying \$500 to Edward E. Embree to act ostensibly as investment manager to approve the purchase and paying \$2,500 to Guttentstein & Lasdon as brokers, Mr. Kenyon appears to have taken about \$227,000 as the net proceeds of the sale by Monthly Income Shares corporations of their Class AA stocks to Investors Fund of America, Inc.

## 2. SALE OF STOCK OF NORTH BERGEN TRUST COMPANY TO MONTHLY INCOME SHARES, INC., OF NEW JERSEY

On May 25, 1936 Mr. Kenyon caused Monthly Income Shares, Inc., of New Jersey, to accept, in partial satisfaction of the indebtedness to that investment company of Kenyon & Company, Inc., 300 shares of his stock of the North Bergen Trust Company at \$115 per share for a total of \$34,500.<sup>140</sup> Later Mr. Kenyon caused Monthly Income Shares, Inc., of New Jersey, to accept an additional block of 50 shares of the North Bergen Trust Company at \$115 per share for a total of \$5,750, which was also to be applied against the indebtedness of Kenyon & Company, Inc.<sup>141</sup> As has been previously indicated, this bank stock had been bought by Mr. Kenyon on March 24, 1936, about two months prior to the above transactions. At that time the former management of the bank had appraised the value of the stock at \$12.30 per share plus its proportionate share of \$39,000 cash contributed to the surplus account of the bank by Monthly Income Shares, Inc., of New Jersey, through Mr. Kenyon. On this basis the bank stock had a value in May 1936 of about \$38.30 per share, or about \$5.83 less than Mr. Kenyon paid for the stock, and \$76.70 per share less than the price at which Mr. Kenyon sold it to the investment company.<sup>142</sup>

## 3. SALE OF STOCK OF NORTH BERGEN TRUST COMPANY TO INVESTORS FUND OF AMERICA, INC.

On June 18, 1936, eight days after Mr. Kenyon acquired control of Investors Fund of America, Inc., and at a meeting of directors held the same day as the meeting at which he caused that company to purchase the Monthly Income Shares stock, he also caused his dummy board of directors to purchase 350 shares of the stock of North Bergen

<sup>140</sup> Op. cit. supra, note 1, at 19605-7. Op. cit. supra, note 3, at 359-60 and Exhibit No. 145-B.

<sup>141</sup> Ibid.

<sup>142</sup> See discussion, supra, pp. 321-4. It will be recalled that Mr. Kenyon had purchased this bank stock with funds borrowed from both the Monthly Income Shares corporations.

Trust Company at \$115 per share.<sup>143</sup> Mr. Kenyon was faced with the same obstacles in consummating this transaction as confronted him in the sale of the stock of the two Monthly Income Shares corporations to Investors Fund of America, Inc. These obstacles were provisions in the trust agreement with the First National Bank of Jersey City, New Jersey, Trustee, requiring (a) the approval of Estate Administration, Inc., for all purchases of securities for the corporation, and (b) that all purchases of securities be made through a New York Stock Exchange firm. Mr. Kenyon solved this problem at the same time and by the same device used in the sale of the stock of the Monthly Income Shares corporations. As has been previously indicated, "Edward Embree & Company" was substituted for Estate Administration, Inc., after his contract with the latter had been canceled in consideration of the \$20,000 and Mr. Embree was paid the \$500 for his services as investment administrator for 30 days.<sup>144</sup> The approval of Mr. Embree of the purchase of the North Bergen Trust Company stock was thereupon secured; and these purchases were cleared through Guttenstein & Lasdon to meet the applicable charter requirement. Investors Fund of America, Inc., paid \$40,250 for the North Bergen Trust Company stock, the check for this amount being issued by the First National Bank of Jersey City, Trustee, to Guttenstein & Lasdon, who in turn endorsed it to Kenyon & Company, Inc., Kenyon's corporate "conduit."<sup>145</sup>

#### 4. REMOVAL OF CHARTER RESTRICTIONS IN INVESTORS FUND OF AMERICA, INC., AND CANCELLATION OF DISTRIBUTION AGREEMENT

Because of the difficulty Mr. Kenyon had met in his plan to place the stock of the Monthly Income Shares companies into the portfolio of Investment Fund of America, Inc., he decided, on or about June 20, 1936, to amend the charters of Investors Fund of America, Inc. and of United Standard Oilfund of America, Inc. He accordingly called a meeting on July 3, 1936, of a number of dealers who had been distributing the stock of these two corporations and submitted to them proposed charter amendments which would remove all restrictions upon the management.<sup>146</sup> Some of the dealers protested both the proposed change and the recent acquisition by Investors Fund of America, Inc. of the Class AA stock of the two Monthly Income Shares corporations.<sup>147</sup> Despite these dealers' objections, notices of a meeting to be held on July 21, 1936 were sent to stockholders of Investors Fund of America, Inc. and United Standard Oilfund of America, Inc. These notices contained, among other things, the statement that the stockholders' investments would be much better protected under the proposed amended charter.<sup>148</sup>

<sup>143</sup> Op. cit. supra, note 1, at 19455f and Commission's Exhibit No. 3074.

<sup>144</sup> Id., at 19510-19 and Commission's Exhibits Nos. 3088 and 3089, and see discussion, supra, pp. 328-34.

<sup>145</sup> Op. cit. supra, note 1, at 19571 and Commission's Exhibit No. 3098.

<sup>146</sup> Id., at 19749-50.

<sup>147</sup> Id., at 19750.

<sup>148</sup> Id., at 19750f and Commission's Exhibit Nos. 3122 and 3123.

On July 20, 1936, Mr. Kenyon effected a settlement with the objecting dealers<sup>149</sup> by causing Investors Fund of America, Inc. and United Standard Oilfund of America, Inc. to repurchase any stock which had been sold by the objecting dealers at a stipulated price. In consideration of these purchases the dealers in effect agreed to vote for the proposed amendments.<sup>150</sup> With the dealers' opposition thus eliminated, the amendments giving the directors unrestricted authority over the corporations' policies were passed at the meeting of stockholders of the respective companies held on July 21, 1936, and the last technical obstacle to Mr. Kenyon's complete domination of these corporations was removed.<sup>151</sup>

Mr. Kenyon's first act under the now unrestricted charters was to cause the cancelation of the management and distribution agreements between the two corporations and their respective sponsor-distributor corporations.<sup>152</sup> On or about August 1, 1936, Mr. Kenyon caused Investors Fund of America, Inc., to pay to United Sponsors, Inc., the sum of \$175,000 for the cancelation of its management and distribution agreement, and United Standard Oilfund of America, Inc. to pay to United Standard Oilshares Corporation the sum of \$60,000 for the cancelation of its management and distribution agreement.<sup>153</sup> These cancelations were effected although each of these sponsor-distributor corporations, as has been previously indicated, had outstanding in the hands of the public an issue of debentures, which were a prior claim on the avails of these distribution agreements and no attempt was made to obtain the consent or even determine the sense of the debenture holders with respect to the cancellation of these agreements.<sup>154</sup> At this time, as far as available records disclose, \$85,000 of debentures of United Sponsors, Inc. were outstanding and \$65,000 of debentures of United Standard Oilshares Corporation were outstanding.<sup>155</sup>

No part of the sums received for the cancelation of these distribution contracts was used to retire the debentures, but instead, such proceeds were turned over to Mr. Kenyon. As to this application of these funds, Norman E. Dizer testified:<sup>156</sup>

Q. Now, as treasurer of United Standard Oilshares, Inc., you probably received the \$175,000 paid by Investors Fund of America, did you not?

A. I don't think I actually received it myself.

Q. Well, do you know what happened to it?

A. I know that \$175,000—there was a large sum received. Now, whether it was \$175,000 or not, I can't say.

Q. Will you recall whether any of the monies that were paid by Investors Fund of America, Inc., were applied to the outstanding bonds of United Sponsors?

A. So far as I know, it was not.

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<sup>149</sup> Id., at 19767-9.

<sup>150</sup> Ibid. and id., Commission's Exhibit No. 3124.

<sup>151</sup> Id., at 19750, 19770-2, 19799, and Commission's Exhibit No. 3128.

<sup>152</sup> Id., at 19612-3, 19620-1.

<sup>153</sup> Id., at 19612-3, 19620-1.

<sup>154</sup> Ibid., and id., at 19627-8.

<sup>155</sup> Id., at 19626-7.

<sup>156</sup> Id., at 19628-9.

Q. Not a single cent of the \$175,000 was applied to the outstanding bonds, is that correct?

A. I believe that is, but I could not say definitely. I believe it is correct.

Q. Can you testify, Mr. Dizer, as treasurer of United Sponsors, Inc., that most, if not all of the \$175,000 went or was loaned out to Donald P. Kenyon?

A. I know a considerable part of the \$175,000 went to Kenyon, but just what portion went, I do not know.

Q. You say a considerable part of the \$175,000 went to Kenyon?

A. Yes.

Mr. Dizer further testified:<sup>157</sup>

Q. Isn't it true that it was no sooner received by United Standard Oilshares than it was immediately paid out?

A. I know quite a bit of it was.

Q. As a director, you know that none of the \$65,000 remained in the treasury of United Standard Oilshares more than a few days after it was received?

A. That is right.

Q. And it has never been returned, any part of it?

A. I can't answer that.

Q. Not one cent of it, Mr. Dizer, was ever applied to the payment of outstanding bonds of United Oilshares?

A. So far as I know, that is right.

As a result of these transactions, the two debenture issues, one in the principal amount of \$85,000 and the other in the principal amount of \$65,000 went into default.<sup>158</sup>

## 5. FURTHER ACTIVITIES IN CONNECTION WITH INVESTORS FUND OF AMERICA, INC. AND UNITED STANDARD OILFUND OF AMERICA, INC.

Upon the termination of the management and distribution agreements with United Sponsors, Inc. and United Standard Oilfund of America, Inc., Mr. Kenyon caused both Investors Fund of America, Inc. and United Standard Oilfund of America, Inc., to enter into distribution agreements with Kenyon & Company, Inc.,<sup>159</sup> which company was to receive a 13½% commission on the gross proceeds of the sale of the stock of both investment companies, and was to maintain an over-the-counter market in the stock of both these companies.<sup>160</sup> To carry on this latter function, Kenyon & Company, Inc. was authorized to borrow up to \$100,000 from Investors Fund of America, Inc.<sup>161</sup> Over \$50,000 was borrowed from that investment company by Kenyon & Company, Inc., the personal company of Mr. Kenyon, ostensibly for purposes of maintaining a market in this stock from the date of the agreement to November 20, 1936.<sup>162</sup> The record does not indicate that the money was used for that purpose.<sup>163</sup> Lucian A. Eddy testified:<sup>164</sup>

<sup>157</sup> Id., at 19639.

<sup>158</sup> Donald P. Kenyon could not be located for service of process at the time of the public examination by the Commission of the affairs of these companies. His attorneys reported that he was somewhere in Texas at the time.

<sup>159</sup> Op. cit. supra, note 1, at 19642-3, 19800.

<sup>160</sup> Id., at 19801.

<sup>161</sup> Id., at 19801-2.

<sup>162</sup> Id., at 19803-6.

<sup>163</sup> Id., at 19806.

<sup>164</sup> Id., at 19805-6.

Q. Do you know whether any of this \$50,000 that was loaned to Mr. Kenyon was applied to maintaining the market by Kenyon and Company, if they were obliged to maintain a market in the securities of Investors' Fund of America?

A. I don't think 5 cents was used for that purpose.

During this same period, that is, from July 21, 1936, to November 20, 1936, Kenyon & Company, Inc. borrowed, received, or otherwise obtained a total of approximately \$50,000 from Investors Fund of America, Inc., in addition to the loans which were ostensibly made for purposes of maintaining a market.<sup>165</sup> Included in this aggregate of \$50,000 was a payment of \$19,000 to Kenyon & Company, Inc., as broker, to purchase for the investment company 19,000 shares of stock of Powell Bouyon, Ltd. at \$1 per share. Kenyon & Company, Inc., never made delivery of the stock to its principal, Investors Fund of America, Inc., but instead the investment company was given a due bill for this stock. Mr. Eddy testified:<sup>166</sup>

Q. Mr. Eddy, do you know whether or not the 19,000 shares of Powell Rouyon stock for which this check was issued were ever delivered to Investors' Fund of America?

A. I don't believe it was ever delivered.

Q. Do you recall how this payment of \$19,000 to Kenyon and Company was charged off on the books of Investors' Fund of America?

A. It was not charged off, but at the time we took over the Kenyon oil property, that \$19,000 was included in the exchange of securities and obligations of Kenyon's to the Fund.

Q. That was on November 20, 1936?

A. It was.

Q. Can you testify as to how that \$19,000 was set up on the books of Investors' Fund of America, between September 12 and November 20, 1936?

A. It was carried as a due bill from Kenyon and Company with a delivery of 19,000 shares of stock.

Q. Was it carried as a due bill for that stock right through until November 20th, or was it charged to an account receivable for Kenyon and Company?

A. I think we had the due bill right up to that time.

## 6. PROCEEDINGS BY ATTORNEYS GENERAL OF NEW JERSEY AND NEW YORK

On July 30, 1936, David Wilentz, Attorney General of New Jersey, instituted, under the New Jersey Blue Sky statutes, a proceeding in equity against Monthly Income Shares, Inc., of New Jersey, Monthly Income Shares, Inc., of New York, Lancaster, Havens & O'Brien, Inc., Lancaster, Gorman & Co., Inc., Kenyon & Company, Inc., National Associated Dealers, Inc., Donald P. Kenyon, Charles Russell Kenyon, Norman E. Dizer, Robert E. Lancaster, and George R. Grantham to enjoin the further sale of any securities in New Jersey. On the same day an order to show cause was issued by the vice chancellor and a custodial receiver of Monthly Income Shares, Inc., of New Jersey was appointed. On October 15, 1936, a decree was signed by the vice chancellor permanently enjoining all the defendants from selling

<sup>165</sup> Id., at 19828.

<sup>166</sup> Id., at 19807-8.

securities in the State of New Jersey and appointing a receiver to liquidate Monthly Income Shares, Inc., of New Jersey.<sup>167</sup>

At or about the same time an investigation of the affairs of Monthly Income Shares, Inc., of New York was being conducted by the Attorney General of New York.<sup>168</sup> Upon the application of the Attorney General of New York, an order was issued by the Supreme Court of the State of New York on September 16, 1936, restraining the alienation of any of the corporation's assets, and a further restraining order to the same effect was issued by the same court on December 12, 1936.<sup>169</sup>

Donald P. Kenyon, apparently realizing that these proceedings would disclose his failure to account for the proceeds of the 115,000 shares of Class AA stock of the Monthly Income Shares, Inc. of New Jersey and 135,000 shares of the Class AA stock of the Monthly Income Shares, Inc., of New York, agreed to repurchase from Investors Fund of America, Inc. these two blocks of stock at \$1.00 per share.<sup>170</sup> the price at which these shares were sold to Investors Fund of America, Inc.

Mr. Kenyon took the stock down on November 20, 1936. However, instead of paying Investors Fund of America, Inc. the sum of \$250,000 in cash, he assigned to that investment company all his interest in a lease on 20 acres of oil property in Galveston County, Texas, and received \$10,000 cash from the investment company for his resignation as officer and director of the investment company.<sup>171</sup> This lease was transferred not only in satisfaction of the repurchase price of the blocks of stock of both the Monthly Income Shares companies but also in full settlement of all amounts or obligations otherwise owed to Investors Fund of America, Inc. by Mr. Kenyon, Kenyon & Company, Inc., and his other dummy corporations.<sup>172</sup> The total of such indebtedness and obligations, including the obligation to repurchase the stock of both Monthly Income Shares companies, was approximately \$364,000.<sup>173</sup>

Mr. Kenyon represented to Investors Fund of America, Inc., that this lease had a fair value far in excess of \$364,000. The appraisal had been made by a firm known as A. S. Bergendahl & Associates, Inc., of Houston, Texas, which had, it appears, a financial interest in the property at the time.<sup>174</sup> A report on this property, prepared by appraisers employed by Investors Fund of America, Inc. subsequent to Mr. Kenyon's resignation indicated that the fair value of these properties was about \$266,000.<sup>175</sup>

It developed that there were several claims against the oil property which would create infirmities in the title of Investors Fund of

<sup>167</sup> Id., at 19823, 19993; *David Wilentz, Attorney General, etc. v. Monthly Income Shares, Inc., et al.*, Chancery 115-349. (Derived from supplementary material supplied the Commission for Investors Fund of America, Inc.)

<sup>168</sup> Op. cit. supra, note 1, at 19824, 20059, 20063f, 20070. See also supplementary material supplied the Commission for Investors Fund of America, Inc.

<sup>169</sup> Op. cit. supra, note 1, at 20070-1.

<sup>170</sup> Id., at 19823-5.

<sup>171</sup> Id., at 19824-5, 19827-8, and 19817.

<sup>172</sup> Id., at 19827-9.

<sup>173</sup> Ibid.

<sup>174</sup> Id., Commission's Exhibit No. 3161.

<sup>175</sup> Id., at 19829-30 and Commission's Exhibit No. 3146. Counsel for Lucian A. Eddy and Investors Fund of America, Inc., at the public examination of these companies purported to show that the fair value of the lease was in fact \$265,000 or more. (Id., at 20087-8.)



America, Inc. to this property unless they were satisfied or successfully contested.<sup>176</sup> Mr. Eddy's counsel stated, however, that he expected this lease within a few years to have a value equal to the amount of Mr. Kenyon's indebtedness, plus interest.<sup>177</sup>

## 7. SALE OF STOCK OF NORTH BERGEN TRUST COMPANY TO MONTHLY INCOME SHARES, INC., OF NEW YORK

On September 2, 1936, Mr. Kenyon caused Monthly Income Shares, Inc., of New York to accept 350 shares of stock of the North Bergen Trust Company at \$115 per share for a total of \$40.250 in partial discharge of the indebtedness then due that corporation from Kenyon & Company, Inc.<sup>178</sup>

## 8. ACTIVITIES IN CONNECTION WITH UNITED STANDARD OILFUND OF AMERICA, INC.

From February 8, 1935, the date of the organization of United Standard Oilfund of America, Inc., to June 1936, the funds of that corporation were being increased by its original management through sales to the public of additional securities and through investments. At June 30, 1936, the corporation had gross assets of \$266,286.61, and net assets of about \$260,000. There were 218,019 shares of stock outstanding, with a liquidating value at the time of about \$1.20 per share.

John R. O'Hanlon, Assistant Attorney General of the State of New York, who had examined the books of the corporation, testified:<sup>179</sup>

A. \* \* \* During the time I have described, from the time of organization to June 30, 1936, the books disclosed a continuous process of building up the fund. It reached its peak at June 30, 1936, at which time there was outstanding 218,019 shares of stock of a par value of 25 cents a share which had been sold at approximately \$1.25 a share. The balance sheet of this trust as of June 30, 1936, was very plain. The assets consisted of only three items—accounts receivable, \$265; cash, \$72,650.70, and marketable securities of \$193,370.91. There were insignificant liabilities, in the amount of about \$5,000, leaving the net assets in a very liquid condition of about \$260,000, and giving the outstanding 218,019 a liquidation value of about \$1.20 a share. And in such a condition that it could have been liquidated in a few hours during a market day.

Upon Mr. Kenyon's acquisition of control the assets of the corporation began to be dissipated. Mr. O'Hanlon testified:<sup>180</sup>

A. \* \* \* Between June 30—I presume it started June 10, but we will take the date of June 30—the progress of the corporation went into reverse, so to speak. From that date on, its activities consisted of the liquidation of securities in the portfolio, cessation of the sale of any further stock, and disbursement of the cash on hand, and the proceeds of the sale of the stock in a manner I will describe \* \* \*

<sup>176</sup> Op. cit. supra, note 1, at 19830-1.

<sup>177</sup> Id., at 20087-8.

<sup>178</sup> Id., at 20066.

<sup>179</sup> Id., at 20078.

<sup>180</sup> Id., at 20079.

The listed securities in the portfolio of that corporation were reduced from \$193,370.91 in June 1936 to \$26,035.68 at February 28, 1937.<sup>181</sup>

However, the corporation did not possess even these \$26,035.68 of listed securities because these securities<sup>182</sup> had been pledged with the North Bergen Trust Company on or about December 15, 1936, for a loan of \$22,000 to Edward Embree, of the non-existent "Edward E. Embree & Company."<sup>183</sup> The proceeds of this loan had been turned over to Mr. Kenyon. Thereafter, on January 14, 1937, on Mr. Kenyon's instructions, the pledged securities were sold through Newburger, Loeb & Company, a New York brokerage firm, for the account of North Bergen Trust Company, for \$29,735.92. The proceeds of this sale were paid over to the trust company, which deducted the amount of its loan and interest and issued a check to Mr. Kenyon for \$7,641.19, representing the balance, which was deposited in his personal bank account.<sup>184</sup>

Mr. O'Hanlon summarized the cash record of the corporation for this period as follows:<sup>185</sup>

A. Now I have made a thorough analysis of the cash in and the cash out of the corporation between June 1936 and March 31, 1937, which is about the date when it died.

Q. The cash in and cash out includes the cash received from the sale of these securities?

A. Cash out, meaning plus the postage of the sale in and then that much out.

As I previously stated, the balance of cash on hand on June 30, 1936, was \$72,650.70. Through liquidation of securities as described, the corporation received in, between June 1936 and February 1937, \$163,188.85. There were also a few other minor receipts—dividends received, \$1,347.00 and about \$10,000 in exchange checks but which presumably the corporation issued in a similar amount.

The total receipts from these sources was \$175,652.25, which, added to the amount on hand at the beginning, makes a total of cash which came into the corporation during this period of \$248,302.95.

Thus, Mr. Kenyon had control of approximately \$250,000 of assets of this company during this period from June 10, 1936, to March 31, 1937. The sum of \$100,500 was lent to Kenyon & Company, Inc., and was evidenced by unsecured notes and accounts receivable. The sum of \$60,000 was paid to United Standard Oilshares Corporation for the cancelation of the management agreement. An additional \$45,216.79 was used to repurchase the shares of stockholders represented by the objecting dealers. Dividends paid amounted to \$8,236.38 and \$13,082.91 was issued as exchange checks. The total of these disbursements, plus salaries, amounted to \$247,387.58, leaving a cash

<sup>181</sup> Ibid.

<sup>182</sup> The portfolio securities of the corporation were sold as follows (ibid.):

July	\$16,452.63
August	45,593.03
September	47,343.75
October	33,001.50
November	3,927.50
December	13,010.40
January	1,601.48
February	6,404.94

<sup>183</sup> Id., at 20083.

<sup>184</sup> Id., at 20083-4.

<sup>185</sup> Id., at 20980.

balance of \$915.37, according to the books of the corporation.<sup>186</sup> Mr. O'Hanlon summarized these transactions as follows:<sup>187</sup>

A. So, summarizing, we can say that all of the cash on hand on June 30 and all of the securities except the \$26,000, which I will refer to later, were converted into cash and used principally to pay monies over to Kenyon, directly or indirectly, and to pay off complaining stockholders.

I also want to say this: At the present time [August 4, 1937] the record discloses that there is outstanding about 180,000 shares of this stock in the hands of the public for which the public paid \$1.25 per share, and there are no liquid assets whatever to meet this liability to stockholders, and the only purported assets on the books which can be considered of value is marketable securities in the amount of \$26,000.

These marketable securities of the value of \$26,000 were the securities which were pledged for the loan of \$22,000 to Mr. Embree,<sup>188</sup> and which were subsequently sold to satisfy this loan and the balance of the proceeds turned over to Mr. Kenyon. This \$26,000 item was therefore completely eliminated. Mr. O'Hanlon testified:<sup>189</sup>

Q. So that at the present time there are how many shares of United Standard Oilfund stock outstanding?

A. 180,000.

Q. And there are absolutely no assets of the company?

A. The only assets would be the receivables from Kenyon & Company, which, from my examination of the books of that company, I know are worthless. The corporation has no assets.

On March 23, 1937, the Supreme Court of the State of New York entered a temporary injunction against Robert E. Lancaster, Donald P. Kenyon, Charles R. Kenyon, Norman E. Dizer, Walter E. O'Brien, Edwin Wallace Havens, George Shaw, Jr., Murray A. Cobb, George R. Grantham, William H. Paynter, Kenyon & Company, Inc., of New York, Monthly Income Shares, Inc. of New York, Lancaster, Havens & O'Brien, Inc., Lancaster, Paynter & Company, Inc., and National Associated Dealers, Inc., and appointed receivers for each of the corporate defendants.<sup>190</sup>

On or about April 4, 1937, the Attorney General of New York ascertained that Mr. Kenyon had alienated the entire portfolio of securities of Monthly Income Shares, Inc., of New York, by pledging such securities to North Bergen Trust Company during December 1936 and permitting such securities to be sold by the bank in January 1937.<sup>191</sup> As this act violated the restraining order of December 12, 1936, a motion to punish Mr. Kenyon for contempt was filed by the Attorney General of New York.<sup>192</sup> So far as available, information discloses this

<sup>186</sup> Id., at 20081. According to the records of the corporation, \$874.40 of this cash was on deposit at the North Bergen Trust Company, and \$40.97 was on deposit at another bank. Mr. O'Hanlon testified that an examination of the records of the two banks indicated that there was only "\$2 or \$3 in each account". (Ibid.)

<sup>187</sup> Id., at 20081-2.

<sup>188</sup> Id., at 20083 and see discussion *supra*, p. 341.

<sup>189</sup> Op. cit. *supra*, note 1, at 20084-5.

<sup>190</sup> Id., at 20071-2 and supplementary information supplied the Commission for Investors Fund of America, Inc.

<sup>191</sup> Op. cit. *supra*, note 1, at 20074-5.

<sup>192</sup> Id., at 20076.

motion was pending at the time of Mr. Kenyon's death in December 1938. However, after this motion was made Mr. Kenyon turned over \$50,000 to the receiver for the company.<sup>193</sup>

## 9. ACTION BY FEDERAL DEPOSIT INSURANCE CORPORATION AGAINST NORTH BERGEN TRUST COMPANY

On April 16, 1937, the Federal Deposit Insurance Corporation, which had issued a membership charter to the North Bergen Trust Company, revoked the charter, after investigation, as of May 1, 1937,<sup>194</sup> assigning the following reasons: (1) Operating with impaired capital; (2) Lending in excess of the maximum limit permissible under the law; and (3) Unwarranted concentration of loans and extension of credit to persons or corporations in which the principal stockholders were financially interested.

In its statement announcing the revocation of the charter the Federal Deposit Insurance Corporation stated:<sup>195</sup>

It was also found that the management of the bank by its principal stockholders constituted a hazard to its depositors and the corporation.

## 10. LOSS TO MONTHLY INCOME SHARES CORPORATION ON THE NORTH BERGEN TRUST COMPANY STOCK

On April 19, 1937, 700 shares of North Bergen Trust Company stock previously sold by Mr. Kenyon at \$115 per share to the two Monthly Income Shares corporations were sold by these companies at substantially less than \$50 per share,<sup>196</sup> resulting in a substantial loss to these two companies.

### E. Kenyon & Company, Incorporated

Kenyon & Company, Incorporated was patently the "conduit" through which Mr. Kenyon effected his various transactions. As was testified by Mr. Dizer:<sup>197</sup>

Q. Mr. Dizer, from your knowledge of the operations of Kenyon and Company, can you testify that Kenyon and Company was used by Donald P. Kenyon merely as a conduit or vehicle by means of which he borrowed money from others and loaned it to himself?

A. Well, I would say that a greater part of the transactions were just that.

Q. And most if not all of the moneys borrowed by Kenyon and Company came from various other corporations controlled by Donald P. Kenyon. Isn't that correct?

A. The greater part of it; yes.

Q. So that eventually all of the moneys borrowed by Kenyon and Company from the various other organizations or corporations in a very short time there-

<sup>193</sup> *People, etc. v. Monthly Income Shares, Inc., et al.* Supreme Court of New York, Kings County (action commenced December 12, 1936). (Derived from supplementary information supplied the Commission for Investors Fund of America, Inc.)

<sup>194</sup> *The New York Times*, April 17, 1937; *op. cit. supra*, note 1, at 19592-5.

<sup>195</sup> *The New York Times*, April 17, 1937.

<sup>196</sup> *Op. cit. supra*, note 1, at 19593.

<sup>197</sup> *Id.*, at 19738.

after found their way into the hands of Donald P. Kenyon and were converted to his own purposes. Correct?

A. I should say that was substantially correct.<sup>198</sup>

Kenyon & Company, Incorporated kept no books of account until the Attorney General of New York demanded the production of such books, at which time Kenyon caused a set of books to be prepared. Mr. O'Hanlon testified:<sup>199</sup>

Q. Did you make any attempt to secure the books of Kenyon & Company, Inc., at this time upon noticing the amount of receivables of that corporation?

A. Yes, sir; I did.

Q. Were you able to get those books?

A. It was on December 12, I think, 1936, I served a subpoena duces tecum on Donald P. Kenyon to produce the books of Kenyon & Company, Inc., within a few days. He stated to me that the books of account of Kenyon & Company were in Texas in the possession of Norman E. Dizer, the treasurer of the company, and he requested some time to have Dizer bring them back and produce them before me. I think it was about three weeks later, pursuant to my direction, Donald Kenyon returned and at that time produced a set of books of Kenyon & Company, Inc., and under questioning, he admitted that the books of account had been written up in the interval between December 12, 1936, and the date of production.

Q. Mr. Kenyon was duly sworn at the time he made these statements?

A. Yes.

Q. So that at the time the loans were negotiated by Monthly Income Shares, Inc., of New York, to Kenyon & Company prior to July 31, 1936, Kenyon & Company were without books?

A. That is correct.

Harold F. Solomon, one of the accountants of the Securities and Exchange Commission who participated in the investigation of these companies, corroborated the fact that Kenyon & Company, Incorporated, was merely an instrumentality of Mr. Kenyon. Mr. Solomon testified:<sup>200</sup>

Q. Mr. Solomon, from your examination and knowledge of the books and affairs of Kenyon & Company, Inc., would you say that, in your opinion, Kenyon & Company was used merely as a vehicle for the loan account of Donald P. Kenyon?

A. In my opinion, moneys were received from various other companies and credited to this account, loans payable account of Donald P. Kenyon, and then the moneys were taken out of that account and were advanced to the account of Donald P. Kenyon.

Mr. Solomon further testified:<sup>201</sup>

Q. And according to that exhibit,<sup>202</sup> Mr. Solomon, the total receipts of the corporation for the period from January to November 1936, were \$907,567.58, is that correct?

A. According to the books of Kenyon & Company that is correct.

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<sup>198</sup> Mr. John R. O'Hanlon, Assistant Attorney General of New York, testified to the same effect. (Id., at 20069-70.)

<sup>199</sup> Id., at 20068.

<sup>200</sup> Id., Commission's Exhibit No. 3121, at 758-9.

<sup>201</sup> Id., Commission's Exhibit No. 3121, at 750-1.

<sup>202</sup> Reference is to Exhibit No. 146-C contained in id., Commission's Exhibit No. 3121.

Q. And also according to Exhibit 146-C of that particular amount \$845,220.55 represented moneys borrowed from or received for the account of Donald P. Kenyon, is that correct?

A. That is correct.

Q. According to the books of Kenyon & Company?

A. According to the books.

Q. And according to that same exhibit, Mr. Solomon, the total disbursements during the same period amounted to \$859,307.81, is that correct?

A. That is only the disbursements for loans payable account of Donald P. Kenyon, advances to Canada, and Texas loans, account of Donald P. Kenyon, and investments purchased.

Q. What other disbursements were there?

A. The salaries and expenses are not included in this summary.

Q. Were you able to ascertain what the total advances were for salaries and expenses?

A. The expenses were \$23,753.80 and salaries were \$24,323.63.

## F. Other Companies and Trusts

There are several other corporations and trusts which came under the control of Mr. Kenyon during the period of the activities under discussion. These organizations have not been previously discussed in detail, since they appear to have been much less severely touched by Mr. Kenyon than were the others. A list of these corporations and trusts includes: Kenyon & Company, Ltd., of Canada, Harriman Investors Fund, Inc., Interstate Investors, Inc., and the following fixed trusts and their depositors:

<i>Trust</i>	<i>Depositor</i>
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Trustee Standard Investment Series "C."	Shares, Trustee Standard Shares, Incorporated.
Trustee Standard Investment Series "D."	Shares, Trustee Standard Shares, Incorporated.
Trustee Standard Oilshares, "A."	Series Standard Oilshares, Inc.
Trustee Standard Oilshares, "B."	Series Standard Oilshares, Inc.
American Composite Trust Shares, Cumulative Series.	American Composite Shares Corporation.
Collateral Trustee Shares, Series "A."	Investment Trust of New York, Inc.
Trusteed New York Bank Shares.	National Associated Dealers, Inc.

### 1. KENYON & COMPANY, LTD. OF CANADA

Kenyon & Company, Ltd. of Canada apparently was a personal corporation of Mr. Kenyon.<sup>203</sup> The available data indicate that the public had no direct or indirect ownership in the company, and apparently it was not used, to any great extent, to assist Mr. Kenyon in his activities within this group.

<sup>203</sup> Op. cit. supra, note 1, at 19682.

## 2. HARRIMAN INVESTORS FUND, INC.

Harriman Investors Fund, Inc., was incorporated under the laws of New York on May 19, 1930, as a restricted management type, open-end investment company with an authorized capital of 50,000 shares of common stock without par value. The Harriman Fund Management Corporation, composed and owned by officers of the Harriman National Bank & Trust Company, was the original sponsor of the company and their bank acted as depositary and transfer agent for the company. The issue was sold to the public at \$101 per share.<sup>204</sup> Quarterly dividends were paid on the stock from September 2, 1930, through March 1, 1936.<sup>205</sup> Control of the company was acquired by Universal Shares, Ltd., then controlled by the Spies-Espey-O'Ryan group in the year 1935, and passed, through them, to Mr. Kenyon on June 10, 1936. A balance sheet of Harriman Investors Fund, Inc., as of June 10, 1936, showed assets of \$105,073, including an item of \$15,614 representing accounts receivable from affiliated companies and \$83,594.47 representing investments in affiliated companies.<sup>206</sup> There were 2,165 shares of stock outstanding at this time.<sup>207</sup> Lucian A. Eddy, president of Investors Fund of America, Inc., and one of the officials retained by Mr. Kenyon after his acquisition of Universal Shares, Ltd., testified that at August 12, 1937, the investment in affiliated companies by Harriman Investors Fund, Inc., was worthless, and should be written off.<sup>208</sup> Mr. Eddy also testified that an item of these total assets, consisting of \$83,594, characterized on the balance sheet as "Investments in Affiliated Companies" was worth a maximum of "five or ten thousand dollars at the outside" at August 12, 1937, and that the company was, in fact, insolvent.<sup>209</sup>

## 3. INTERSTATE INVESTORS, INC.

Interstate Investors, Inc., was incorporated some time prior to 1935 under the sponsorship of Murray R. Spies and his associates. Apparently the company neither made a general public offering of its stock nor acquired any assets. However, before Mr. Kenyon's acquisition of that company, the predecessor sponsors caused 667 shares of its stock to be sold to Universal Shares, Ltd.<sup>210</sup> Mr. Eddy testified that this stock was worthless at August 12, 1937.<sup>211</sup>

## 4. THE FIXED INVESTMENT TRUSTS IN THE GROUP <sup>212</sup>

By the acquisition by Mr. Kenyon on June 10, 1936 of Universal Shares, Ltd. he obtained control of the following fixed trusts and their depositor corporations.<sup>213</sup>

<sup>204</sup> Standard Stock Offerings, 1936; see note 200, *supra*.

<sup>205</sup> *Moody's Manual of Investments, Banks, etc.*, 1936, p. 1581. No replies to the Commission's questionnaire or summary statement were filed with the Commission.

<sup>206</sup> *Op. cit. supra*, note 1. Commission's Exhibit No. 3105 (Exhibit 7-a thereof).

<sup>207</sup> *Ibid*.

<sup>208</sup> *Id.*, at 19985.

<sup>209</sup> *Id.*, at 19985-6.

<sup>210</sup> *Id.*, Commission's Exhibit No. 3105 (Schedule 1-a, thereof).

<sup>211</sup> *Id.*, at 19981.

<sup>212</sup> For a detailed discussion of these fixed trusts see the Commission's Report on Fixed and Semifixed Investment Trusts.

<sup>213</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. 3104.

*Trust**Depositor*

- |  |  |
|--|--|
| (1) Trustee Standard Investment Trust    | Trustee Standard Shares, Incorporated. |
| Shares, Series C.                        |  |
| (2) Trustee Standard Investment Trust    | Trustee Standard Shares, Incorporated. |
| Shares, Series D.                        |  |
| (3) Trustee Standard Oilshares,          | Standard Oilshares, Inc.               |
| Series A.                                |  |
| (4) Trustee Standard Oilshares,          | Standard Oilshares, Inc.               |
| Series B.                                |  |
| (5) American Composite Trust Shares,     | American Composite Shares Corpora-     |
| Cumulative Series.                       | tion.                                  |
| (6) Collateral Trustee Shares, Series A. | Investment Trust of New York, Inc.     |

Mr. Eddy testified that the principal purpose in acquiring the sponsorship of these trusts was to obtain a list of shareholders who could be induced to exchange their shares for shares of the investment companies which the Spies-Espey-O'Ryan group sponsored.<sup>214</sup> The first four of these trusts had been originally organized and sponsored by Dwelly, Pearce & Company, Inc.,<sup>215</sup> which was paid by the Spies-Espey-O'Ryan group for the transfer of control, a total of about \$100,000.<sup>216</sup> On August 12, 1937, these four fixed trusts had shares outstanding with a total asset value of about \$8,500,000,<sup>217</sup> although their asset value had been about \$10,000,000 when the Spies-Espey-O'Ryan group acquired these trusts.<sup>218</sup>

American Composite Trust Shares, Cumulative Series, had been sponsored originally by E. F. Gillespie & Company, Inc., a firm of investment dealers of New York,<sup>219</sup> and had shares with a total asset value of about \$600,000 outstanding in 1933. This fixed trust has since been liquidated.<sup>220</sup> Collateral Trustee Shares, Series A, whose depositor was Investment Trust of New York, Inc., had shares outstanding with a total asset value of \$700,000 or \$800,000 in 1933. Through liquidations and exchanges this amount had been reduced to about \$400,000 in August 1937.<sup>221</sup>

Trusteed New York Bank Shares was a fixed trust for which National Associated Dealers, Inc., was depositor by succession, and has no particular significance in this report.

### G. Indictment of Donald P. Kenyon's Associates

On March 30, 1939, the Federal Grand Jury for the Southern District of New York returned an indictment against E. Fairbanks Chase, Norman E. Dizer, Lucian A. Eddy, Edward E. Embree, George R. Grantham, Charles Russell Kenyon, Ernest K. Schwartz, Samuel Sobel, Stanley R. Wayne, otherwise known as Stanley R. Weinstein, Kenyon & Company, Inc., and Weil Management Company, Inc., for violations of the fraud provisions of the Securities Act of 1933 and the Mail Fraud and Conspiracy Statutes, the vio-

<sup>214</sup> *Id.*, at 19966-7.

<sup>215</sup> *Id.*, at 19967.

<sup>216</sup> *Ibid.*

<sup>217</sup> *Id.*, at 19969.

<sup>218</sup> *Ibid.*

<sup>219</sup> *Id.*, at 19961. Its depositor was American Composite Shares Corporation.

<sup>220</sup> *Id.*, at 19965.

<sup>221</sup> *Id.*, at 19964.



lations consisting of various of the activities previously discussed herein. Donald P. Kenyon was not indicted because he had died on or about December 27, 1938.<sup>222</sup> The indictment contained seven counts alleging violations of the mail fraud statutes, one count alleging conspiracy to violate the mail fraud statutes and three counts alleging violations of the Securities Act of 1933.<sup>223</sup>

The history of the Kenyon group of companies illustrates the facility with which promoters, with an outlay of an insignificant amount of funds, can gain control of investment companies through the simple device of using the funds of one investment company to purchase control of other companies—acquisitions which may be effected without the knowledge or consent of the stockholders, either of the acquiring or acquired companies. With an initial investment of \$2,300 in December 1935, Donald P. Kenyon by this technique had within 6 months secured control of an aggregate of 31 organizations, including 7 management investment companies, 6 fixed investment trusts, 1 banking and trust company, and 17 distributing management, holding, or depositor corporations. The aggregate assets of all these organizations at their respective acquisition dates totaled more than \$14,000,000, the bulk of which assets had been contributed by the public.<sup>224</sup>

Immediately upon the assumption of control and during the one-year period of dominance of these organizations, the controlling individuals consistently violated their obligations to these organizations and their shareholders. The protective provisions in the articles of incorporation of various of these controlled investment companies were modified or eliminated on the basis of inadequate disclosure to their stockholders.

<sup>222</sup> See Commission's Release, Securities Act of 1933, No. 1933.

<sup>223</sup> See *United States of America v. Sobel et al.*, United States District Court for the Southern District of New York, Docket C-104-37 (1939).

Charles Russell Kenyon, George R. Grantham, and Norman E. Dizer pleaded guilty to the indictments. Lucian A. Eddy, Samuel Sobel, Ernest K. Schwartz, Edward E. Embree, Kenyon & Co., Inc., Weil Management Company, Inc., Stanley R. Wayne, alias Stanley R. Weinstein, and E. Fairbanks Chase pleaded not guilty. After the transmittal of this Report to the Congress, all the defendants who had pleaded not guilty, except Wayne and Chase, were tried and on November 22, 1939 were convicted. Samuel Sobel was convicted on three mail fraud counts, on the conspiracy count and on one count alleging violation of the Securities Act of 1933; Lucian A. Eddy was convicted on one mail fraud count, on the conspiracy count and on one count alleging violation of the Securities Act of 1933; Edward E. Embree was convicted on the conspiracy count and on the count alleging violation of the Securities Act of 1933; Ernest K. Schwartz was convicted on the conspiracy count; Kenyon & Co., Inc. was convicted on all counts of the indictment, and Weil Management Company, Inc. was convicted on one mail fraud count and on the conspiracy count. (Ibid.) At December 1, 1939 Wayne, alias Weinstein, and Chase had not been tried. (Ibid.)

<sup>224</sup> This figure is based on material contained in id., Commission's Exhibits Nos. 3083 and 3084, for figures on the Monthly Income Shares group, id., Commission's Exhibit No. 3105, for the Universal Share group, material supplied in the summary statement filed with the Commission for Alpha Shares, Inc., and on Bankers Directory, Rand McNally & Company, 1936 (1st ed.), p. 762, for information on the North Bergen Trust Company. The approximate totals for each group are as follows:

Name of organization:	Date of acquisition	Total assets
(1) Alpha Shares, Inc.-----	12/10/35	\$42,723
(2) Monthly Income Shares group-----	2/14/36	350,000
(3) North Bergen Trust Co.-----	3/24/36	1,155,000
(4) Universal Shares, Ltd., group-----	6/10/36	13,000,000

The investment companies were caused to lend large sums of money to these individuals and their dummy corporations, many of which loans were made in violation of the provisions of the articles of incorporation and most of which were either never repaid or were only repaid when law suits or criminal prosecution became imminent. The investment companies were caused to create and issue junior preferred stock which were sold to the other controlled investment companies on the representation that such stock was senior preferred stock and the proceeds of the sale of this stock were never turned over to the issuing company but were retained by these individuals.

The controlled distribution companies were compelled to cancel their distribution and management agreements with the controlled investment companies but the large sums of cash paid to the distribution companies as the consideration for these cancellations were immediately appropriated by these controlling individuals. The controlled bank was caused to make large loans to Kenyon, his associates and controlled corporations and the conservative investment securities of the bank were replaced with speculative common stock. Funds of these controlled investment companies turned over to these individuals to purchase securities for these companies were misappropriated and the securities never delivered. Various blocks of stock were sold by these individuals to the various controlled investment companies at grossly excessive prices, or sold through dummy corporations, as brokers, at exorbitant commissions. As a result of these misappropriations, the debentures of the distribution companies went into default and little assets remained for distribution to these debenture holders. As a result of the activities in connection with the bank, the capital of the bank was impaired and the bank subsequently was deprived of its membership in the Federal Deposit Insurance Corporation.

When stockholders of the various investment companies who were represented by dealers complained of the acts of these controlling individuals, the shares of these stockholders were repurchased at excessive prices, while the unrepresented stockholders were not informed of these repurchases.

The total of the funds obtained in these various ways by Mr. Kenyon and his associates from the controlled companies was over \$900,000. The aggregate amount which these individuals either paid for control of the various groups of companies or repaid to the companies or their receivers after discovery of these misappropriations up to December 27, 1938, the date of Mr. Kenyon's death, amounted to about \$500,000, resulting in a net benefit to Mr. Kenyon and his associates of at least \$400,000. As a result of these transactions and activities of these individuals a number of the investment companies were compelled to go into receivership, or became hopelessly insolvent. On March 30, 1939, various individual associates of Mr. Kenyon were indicted by the Federal Grand Jury for the Southern District of New York on account of the foregoing activities and transactions.<sup>225</sup>

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<sup>225</sup> See note 223. *supra*.

## IX. ACQUISITION OF CONTROL BY FISCAL MANAGEMENT GROUP AND NORTHERN FISCAL GROUP OF FIRST INCOME TRADING CORPORATION, CONTINENTAL SECURITIES CORPORATION, CORPORATE ADMINISTRATION, INC., REYNOLDS INVESTING COMPANY, INC., INSURANSHARES CORPORATION OF DELAWARE, BOND AND SHARE TRADING CORPORATION, AND BURCO, INC.

### A. Summary

#### 1. ACTIVITIES OF FISCAL MANAGEMENT GROUP

In August 1937, a group of individuals including Philip A. Frear, George H. Clayton, Jr., Vincent Ferretti, and others (working through a personal holding company known as the Fiscal Management Company, Ltd.), hereafter referred to as the Fiscal Management group, devised a plan whereby they could obtain control of various investment companies without the expenditure of any of their own funds. In essence, their scheme was to contract to buy a controlling block of stock of an investment company; to pay for this block of stock with funds borrowed on the portfolio securities of the very investment company to be acquired; to take control of the investment company and immediately liquidate the portfolio securities to raise the cash needed to pay off the loan; to transfer the controlling block of stock to the Fiscal Management Company, Ltd., their personal holding company; to reimburse the investment company for its portfolio securities sold by transferring to the investment company preferred stock of the Fiscal Management Company, Ltd., and other securities of doubtful value; and to take in connection with these transactions substantial commissions and profits. Having once acquired control of an investment company the group used the funds of this company to acquire control of other investment companies. As a result of these transactions, these individuals, besides taking substantial commissions and profits, obtained control of a top company of a pyramided system of investment companies without the investment by them of any personal funds.

##### a. First Income Trading Corporation

The first investment company to be acquired by the Fiscal Management group was First Income Trading Corporation which had total assets of approximately \$540,000. On August 5, 1937, Harold B. Grow, Albert S. Wicks, and their associates contracted to sell all of their Class A management stock (the sole voting stock) of First Income Trading Corporation which they had acquired at a nominal cost. The Fiscal Management group borrowed \$110,000, the purchase price of the control stock of First Income Trading Corporation, from the brokerage firm of Paine, Webber & Co., members of the New York Stock Exchange, and turned over to that firm portfolio securities of the investment company which had cost \$182,500. Paine, Webber & Co. sold these securities in the market for \$152,000; deducted its advance of \$110,000 and turned over the \$42,000 balance of the proceeds to the members of the Fiscal Management group, who retained this balance as their "commissions" or "profit" on the deal. The group then transferred the control block of stock to their personal holding company, the Fiscal Management Company, Ltd., a Canadian corporation, and received 1,825 shares of \$100 preference stock and 19,995 shares of common stock (all the outstanding common) of Fiscal Management Company, Ltd. The portfolio securities of First Income Trading Corporation sold by the group were replaced with the 1,825 shares of the preferred stock of Fiscal Management Company, Ltd., which then had as its only asset the Class A management stock of First Income Trading Corporation. As a result of these transactions, the members of the group made a "profit" of \$42,000 and acquired indirect control of First Income Trading Corporation through their control of Fiscal Management Company, Ltd., which controlled First Income Trading Corporation. The balance of the portfolio securities of First Income Trading Corporation were subsequently liquidated by the group and the Funds derived were used: (1) to purchase securities of Barkley-Grow

Aircraft Corporation, a company with which Mr. Grow was associated; (2) to make personal advances to Messrs. Grow and Wicks; (3) to make loans to associates of the members of the Fiscal Management group; and (4) to purchase from Mr. Clayton and others securities of dubious value. Subsequently, First Income Trading Corporation was taken over by the Michigan State Securities Commission for liquidation.

### b. Continental Securities Corporation

The second investment company to be acquired by the Fiscal Management group was Continental Securities Corporation. On October 25, 1937, J. Henry Schroder Banking Corporation, the sponsor, manager, distributor of the securities of, and owner of approximately 26,000 shares or 44% of the outstanding common stock of Continental Securities Corporation, contracted to sell this stock plus an additional 3,000 shares at \$20 a share, or a total of \$580,000, ostensibly to one Alexander Beverly, a member of the Fiscal Management group. The net capital contributed to Continental Securities Corporation, during the management period of J. Henry Schroder Banking Corporation, after giving effect to repurchases and dividends, amounted to \$6,000,000 whereas the net assets at October 1937 amounted to \$3,300,000. At the time of sale the common stock, which had originally cost J. Henry Schroder Banking Corporation \$430,000, had a negative asset value and all of the assets of the Continental Securities Corporation "belonged" to the holders of its debentures and preferred stock. The Fiscal Management group borrowed the \$580,000, the purchase price of the control stock of Continental Securities Corporation, from Paine, Webber & Co., and turned over to that firm the portfolio securities of the investment company. Paine, Webber & Co., sold portfolio securities with a market of \$850,000; deducted its advance of \$580,000; turned over approximately \$114,000 to members of the Fiscal Management group, which they retained as their "commission," and turned over the balance of \$156,000 to Continental Securities Corporation. The group then transferred this control stock of Continental Securities Corporation to Fiscal Management Company, Ltd., and received 7,000 shares of that company's preferred stock. The portfolio securities of Continental Securities Corporation sold by the group were replaced with 7,000 shares of the \$100 preference stock of Fiscal Management Company, Ltd., which then had as its only assets the Class A management stock of First Income Trading Corporation (with a nominal asset value) and the control stock of Continental Securities Corporation (with a negative asset value). As a result of these transactions, the members of the group not only made a "profit" of \$114,000 but acquired indirect control of Continental Securities Corporation through Fiscal Management Company, Ltd. The balance of the portfolio securities of Continental Securities Corporation were subsequently liquidated and the proceeds used: (1) To attempt to purchase collateral notes of the South American Utilities Corporation, a venture with which Alexander Beverly was associated; (2) to make personal advances to the New York Stock Exchange brokerage firm Prentice & Brady, which was associated with the Fiscal Management group; (3) to make loans to members and associates of the group; (4) to purchase control of Corporate Administration, Inc., which controlled Administered Fund Second, Inc., an open-end investment company; and (5) to purchase control of Reynolds Investing Company, Inc., another investment company. In March 1938 proceedings were instituted to reorganize the Continental Securities Corporation under section 77B of the Bankruptcy Act.

### c. Corporate Administration, Inc.

The third company to be acquired by the Fiscal Management group was Corporate Administration, Inc. In November 1937, Gilbert Ottley and Robert Strange, who had organized Corporate Administration, Inc., which in turn had sponsored, managed, and distributed the securities of Administered Fund Second, Inc., an open-end investment company, contracted to sell to the Fiscal Management group for \$250,000 the entire common stock of Corporate Administration, Inc. The only asset of Corporate Administration, Inc., was its management and distributing contract with Administered Fund Second, Inc., upon which contract Messrs. Strange and Ottley had up to that time sustained substantial losses. The Fiscal Management group caused Continental Securities Corporation, which the group controlled, to acquire this control stock of Corporate Administration, Inc.,

for \$354,000, of which amount \$250,000 was paid to Messrs. Ottley and Strange, and the balance was retained by the members of the group as "commissions" or "profits" on the deal. The assets of Administered Fund Second, Inc., which was controlled by Corporate Administration, Inc., were not disturbed by the Fiscal Management group, apparently because of the charter restrictions relating to the investment policy of Administered Fund Second, Inc. In August 1937 the control block of stock of Corporate Administration, Inc., was sold by the trustee in reorganization of Continental Securities Corporation for \$5,000, or at a loss of \$349,000 to Continental Securities Corporation.

#### d. Reynolds Investing Company, Inc.

The fourth investment company to be acquired by the Fiscal Management group was Reynolds Investing Company, Inc. On December 31, 1937, the C. K. Reynolds family, which had sponsored, distributed the securities of, managed, and controlled Reynolds Investing Company, Inc., contracted to sell approximately one million shares, a controlling block, of the common stock of that company for approximately \$2,100,000 to Sartell Prentice, a partner in the brokerage firm of Prentice & Brady. The net capital contributed to Reynolds Investing Company, Inc., after deductions for repurchases and dividends, during the management period of the Reynolds family amounted to approximately \$12,000,000, while assets amounted to \$5,000,000 at December 1937. At the time of sale, the common stock which had originally cost the Reynolds family approximately \$1,000,000 had an asset value of 4¢ a share or a total asset value of only approximately \$40,000. Sartell Prentice was in fact, however, only the ostensible purchaser since the Fiscal Management group was causing Continental Securities Corporation, which the group controlled, to purchase control of Reynolds Investing Company, Inc. Continental Securities Corporation paid on this contract a total of \$1,900,000 with the proceeds derived from the liquidation of its portfolio securities. The balance of approximately \$200,000 was furnished by First Income Trading Corporation, controlled by the group. Approximately \$900,000 of the funds needed by Continental Securities Corporation was raised by its sale of its block of 8,825 shares of preferred stock of Fiscal Management Company, Ltd., to Reynolds Investing Company, Inc. In May 1938 the debenture holders of Reynolds Investing Company, Inc., instituted proceedings for the reorganization of that company under Section 77B of the Bankruptcy Act.

## 2. ACTIVITIES OF NORTHERN FISCAL GROUP

Commencing in December 1937, a group of individuals (working through their personal holding company known as the Northern Fiscal Corporation, Ltd.), started an independent program, similar to that used by the Fiscal Management group, to acquire control of various investment companies. This group, hereinafter referred to as the Northern Fiscal group, included S. Leo Solomont, Ralph H. Robb, and Thomas W. Morris, who had been associated with the Fiscal Management group in their acquisition activities.

#### a. Insuranshares Corporation of Delaware

The first investment company acquired by the Northern Fiscal group was Insuranshares Corporation of Delaware. On December 21, 1937, Harry M. Blair, chairman of the Board of Insuranshares Corporation of Delaware, contracted to sell 78,260 shares of the common stock of Insuranshares Corporation of Delaware to the Northern Fiscal group, for a total of \$310,000. The net capital contributed to Insuranshares Corporation of Delaware had depreciated under various managements from approximately \$14,000,000 to \$800,000, as a result of the dissipation of its assets by a group which had acquired control of the investment company in 1932 by methods almost identical with those used by the Northern Fiscal group. The Northern Fiscal group borrowed the \$310,000, the purchase price of the stock of Insuranshares Corporation of Delaware, from the brokerage firm of Paine, Webber & Company and turned over to that firm portfolio securities of the investment company with a market value of \$500,000. Paine, Webber & Company sold these securities, deducted its advance of \$310,000, and turned over a balance of \$152,000 to the members of the group. The group then transferred the stock of Insuranshares Corporation of Delaware to their personal

holding company, the Northern Fiscal Corporation, Ltd., a Canadian corporation specifically organized in connection with the group's acquisition program, and received 5,000 shares of \$100 preference stock of Northern Fiscal Corporation, Ltd. The portfolio securities of Insuranshares Corporation of Delaware sold by the group were replaced with the 5,000 shares of the preferred stock of the Northern Fiscal Corporation, Ltd., which then had among its assets the block of stock of Insuranshares Corporation of Delaware. In June 1938 Insuranshares Corporation of Delaware was placed in receivership.

### b. Bond and Share Trading Corporation

The second investment company acquired by the Northern Fiscal group was Bond and Share Trading Corporation.

In January 1938 Frank E. Erwin and William A. Gutekunst, who had sponsored and managed Bond and Share Trading Corporation, contracted to sell to Insuranshares Corporation of Delaware, blocks of Class A stock and Class B stock of Bond and Share Trading Corporation, representing a controlling interest in that investment company, for a total of \$153,000. The net contributed capital of Bond and Share Trading Corporation had depreciated during the management period of Messrs. Erwin and Gutekunst from \$313,000 to \$232,000. Although the contract was signed by Insuranshares Corporation of Delaware, the Northern Fiscal Corporation, Ltd., paid for the stock with its uncertified check of \$131,000 drawn to the order of Insuranshares Corporation of Delaware, and \$22,000 in cash. This uncertified check was endorsed by Insuranshares Corporation of Delaware to Mr. Gutekunst and his associates, who in turn endorsed the check to Bond and Share Trading Corporation. For this endorsement Messrs. Erwin and Gutekunst received from Bond and Share Trading Corporation about half the portfolio securities of Bond and Share Trading Corporation, valued at \$131,000. As a result of these transactions, Messrs. Erwin and Gutekunst were paid for the control stock of Bond and Share Trading Corporation by the delivery to them of over one-half the portfolio securities of Bond and Share Trading Corporation. The group transferred the control block of stock of Bond and Share Trading Corporation to Northern Fiscal Corporation, Ltd., in satisfaction of the debt created by the issuance of the \$131,000 check by Northern Fiscal Corporation, Ltd. Bond and Share Trading Corporation then transferred the \$131,000 check which it received for the more than one-half of its portfolio securities transferred to Messrs. Erwin and Gutekunst, plus \$44,000 in cash, to Insuranshares Corporation of Delaware, in consideration of the transfer to Bond and Share Trading Corporation by Insuranshares Corporation of Delaware of 1,750 shares of the \$100 preferred stock of Northern Fiscal Corporation, Ltd. Insuranshares Corporation of Delaware then transferred the \$131,000 check and the \$44,000 in cash to Northern Fiscal Corporation, Ltd., in consideration of the transfer to Insuranshares Corporation of Delaware of the control block of stock of Bond and Share Trading Corporation. As a result of these transactions the Northern Fiscal Corporation, Ltd., not only received back its \$131,000 check but also \$44,000 in cash derived originally by Bond and Share Trading Corporation from the liquidation of its portfolio securities; and Bond and Share Trading Corporation was controlled by Insuranshares Corporation of Delaware which in turn was controlled by Northern Fiscal Corporation, Ltd. Bond and Share Trading Corporation, in lieu of approximately  $\frac{3}{4}$  of its original portfolio had 1,750 shares of the preferred stock of Northern Fiscal Corporation, Ltd.

### c. Burco, Inc.

The last investment company to be acquired by the Northern Fiscal group was Burco, Inc. On March 3, 1938, Carroll E. Gray, Jr., who owned 36,000 shares, or 38% of the outstanding common stock of Burco, Inc., contracted to sell this block of stock to the Northern Fiscal group for a total of \$340,000. The assets of Burco, Inc., had depreciated from the time of its organization from approximately \$2,300,000 to \$1,250,000. At the time of sale, this block of common stock which had originally cost Mr. Gray \$158,000, had a negative asset value; and all of the assets of Burco, Inc., "belonged" to the holders of its preferred stock. The Northern Fiscal group borrowed \$290,000 from Paine, Webber & Company, supplying \$50,000 of their own funds, to pay the purchase price of the block of Burco, Inc., stock, and turned over portfolio securities of Burco, Inc., with a



market value of \$750,000. Paine, Webber & Company sold part of these securities, deducted its advance of \$290,000; turned over the balance of the cash and the unsold portfolio securities to Burco, Inc., which in turn transferred them to one Howard F. Hansell, Jr., a member of the Northern Fiscal group, who had in the meantime sold to Burco, Inc., for \$750,000, 25,000 shares of the common stock of Insuranshares Corporation of Delaware and 325,000 shares of the common stock of Delta Oil Company, Ltd., which were of doubtful value. In June 1938, Burco, Inc., was placed in receivership.

## **B. Activities of Fiscal Management Group in Acquisition of Control of First Income Trading Corporation, Continental Securities Corporation, Corporate Administration, Inc., and Reynolds Investing Company, Inc.**

### **1. INTRODUCTION—PLAN OF ACQUISITION**

In August 1937, a group of individuals, including Philip A. Frear, George H. Clayton, Jr., and Vincent E. Ferretti,<sup>1</sup> none of whom had ever been previously connected with the sponsorship of any investment company, conceived a plan whereby they could acquire control of a number of investment companies by paying for this control with the assets of the very companies acquired.<sup>2</sup> This group, with the assistance of various other individuals, ultimately acquired control, in the order named, of First Income Trading Corporation, Continental Securities Corporation, Corporate Administration, Inc., and Reynolds Investing Company, Inc. The participants in the group which acquired control of these investment companies, working through their personally owned holding company organized in Canada and known as the Fiscal Management Company, Ltd., will hereinafter be referred to in this report as the Fiscal Management group.

The *modus operandi* pursued by the Fiscal Management group in effecting the acquisition of control of investment companies was briefly as follows: the group would offer to purchase from the exist-

<sup>1</sup> Philip A. Frear had a small investment banking house in Washington, D. C., known as Frear & Company. (Public Examination, First Income Trading Corporation et al., at 555-6.) Mr. Frear, in connection with the acquisition of the control of First Income Trading Corporation, had borrowed \$5,000 from one F. S. Grape and paid him \$1,500 interest for a 12-day loan in addition to giving him an interest in the holding company that was to take over the control of First Income Trading Corporation. (Id., at 556-9.) At the same time, Mr. Frear borrowed \$2,500 from one Fred Ross. (Id., at 558.) The record indicates that Mr. Frear expected to repay the Grape and Ross loans with the money which he would obtain from First Income Trading Corporation. (Id., at 559.) The loan from Mr. Ross, for which Mr. Frear promised to pay back twice as much as he borrowed from him, was initially contracted for the use in the contemplated acquisition of control of Investors Fund of America (id., at 1584-5), which was never effected. (Id., at 1586.) In connection with this latter unconsummated transaction, Mr. Frear also borrowed \$5,000 from his father, James Frear. (Id., at 1585.)

George H. Clayton, Jr., was, the record indicates, a close associate of the brokerage house of Prentice & Brady. He shared office space with Jerome C. Brady a partner in that firm, and was apparently on very friendly terms with both the partners in the firm. (Id., at 581, 1491.) There is no evidence that he had, prior to these transactions, participated in the activities of any investment company.

Vincent E. Ferretti was an attorney who, at first, had been counsel to Mr. Espy when he attempted to acquire control of Investors Fund of America. (Id., at 1588, 1597.) It was through Mr. Espy that Mr. Frear met Mr. Ferretti, and thereafter together they participated in the acquisition of investment companies. (Id., at 1592.)

<sup>2</sup> Id., at 562-3.

ing management of an investment company the control block of stock of such company at a price far in excess of its market value or asset value. The group would then pay for this control stock by obtaining a loan from a brokerage firm on a list of the portfolio securities of the investment company. Immediately upon obtaining such control, the group would liquidate a portion of the portfolio securities of the investment company and from the proceeds of such sale would repay the advance of the brokerage firm. To "reimburse" the investment company for its portfolio securities which were sold, the members of the group would transfer to the investment company securities of their own personal holding company or other securities of dubious value. A portion of the remaining funds of the acquired investment company would then be used to acquire control of other investment companies.

In the course of these acquisition transactions and of their management of the investment companies, the members of the group would make loans to themselves and would pay themselves substantial commissions and make substantial profits on the deals effected with the investment companies.

## 2. ACQUISITION OF CONTROL OF FIRST INCOME TRADING CORPORATION

The first investment company of which the Fiscal Management group acquired control was First Income Trading Corporation, a general management investment company. First Income Trading Corporation had been organized on April 27, 1933 under the laws of Delaware by Albert S. Wicks, Harold B. Grow, Henry S. Sanger, and Morris S. Bode.<sup>3</sup> This company had two classes of capital stock outstanding, Class A stock and Class B stock. The Class A stock had the sole voting power<sup>4</sup> and the total amount outstanding, 25,000 shares, had been issued to these organizers principally as compensation for their services in connection with the organization and continued management of the company.<sup>5</sup> The Class A stock was entitled to a prior claim of \$5,000<sup>6</sup> upon liquidation of the company but had no further right to any participation in the assets of the

<sup>3</sup> Id., Commission's Exhibit No. 2. Harold B. Grow, a graduate of the U. S. Naval Academy, was in the United States Navy until 1931 when he organized Aviation Industrial Corporation. This venture was not successful, and he thereafter organized the Graham-Grow Company, which specialized as aviation consultants. In 1932, Mr. Wicks approached Mr. Grow with the idea of organizing First Income Trading Corporation, which constituted his first experience with management of investment companies. (Id., at 122-3.)

Albert S. Wicks had been a public accountant, and immediately prior to his organization of First Income Trading Corp., had been in the securities business. (Id., at 125.)

Henry S. Sanger of Detroit, at the time of his association with the investment company, had had no business experience. (Id., at 125.)

<sup>4</sup> Id., Commission's Exhibit No. 2.

<sup>5</sup> Messrs. Wicks, Bode, and Grow received 75% of the Class A stock for services rendered in connection with the organization of First Income Trading Corp., for their disbursements in connection with such organization, which aggregated approximately \$1,500, and also for their continued management of the company. (Id., at 126-7, 132-3.) The remaining 25% of the stock was issued to Henry S. Sanger and William M. Jay at the price of \$30 a share. (Id., at 127-8.)

<sup>6</sup> Id., at 128 and Commission's Exhibit No. 2. Mr. Grow testified that the value of \$5,000 was merely arbitrary and was intended to compensate the holders of the Class A stock for the expenses they incurred in organizing the company.



company. The holders of this stock were entitled in addition, to receive 25% of the annual net profits of the company.<sup>7</sup> However, from the inception of this company (April 27, 1933) to the date of the sale of this stock to the Fiscal Management group (August 1937) the holders of the Class A stock had received only \$16,000.<sup>8</sup>

The Class B stock, which had no voting power, was offered and sold to the public. As of August 1937, the month during which the Fiscal Management group acquired control, 153,000 shares of the Class B nonvoting stock were outstanding in the hands of approximately 600 stockholders.<sup>9</sup> The sales literature used in connection with the public distribution of the Class B stock indicated that the Class A voting stock had been issued to the managers and organizers of the company, and stressed the importance of honest management for the successful administration of an investment company. For example, one circular stated:<sup>10</sup>

Concerning *Management* there can little be said; a man is of unquestionable honesty or he is not. Records are available on most men of any prestige and the question of the integrity of a group is usually one of record. However, actions and attitudes can be thoroughly "honest" or "honest within the law." There is a wide divergence there. The men at the head of the investment machine should be "honest" in the sense that they are thoroughly awake to the sacred nature of the trust imposed upon them and imbued with a real spirit of "Service"—Service being foremost in their minds as opposed to personal gain or reward. In other words, the management must be thoroughly honest and willing to subordinate personal "*gain*" to "*service*," knowing that if service is well rendered *Reward* will come automatically.

Mr. Grow, president of the investment company, admitted that the public probably purchased the stock of the company to a large extent in reliance on the continued management of the company by the original organizers. Mr. Grow testified:<sup>11</sup>

Q. You had prepared a great deal of literature and advertised the fact that you were associated with the First Income Trading Corporation, and that you were going to handle the money of those people, isn't that so?

A. That is right.

Q. And I assume that by virtue of your reputation that there was a very good possibility that people, having reliance and faith in you, purchased the stock at \$5.00 a share; isn't that so?

A. There is no question about that.

\* \* \* \* \*

Q. \* \* \* there is no question in your mind that people in the area where you were relied on the fact that you were the one that was going to handle their money and manage their money and they bought that stock at \$5.00 a share, isn't that so?

<sup>7</sup> Id., Commission's Exhibit No. 2.

<sup>8</sup> Mr. Grow testified that the holders of the Class A stock had received no distribution on their stock during the first three and one-half years of the company's existence. (Id., at 338-9.) During the last year, they had received \$16,000, of which Grow himself received \$6,000. (Id., at 329.)

<sup>9</sup> Id., at 147 and Commission's Exhibit No. 5.

<sup>10</sup> Id., Commission's Exhibit No. 22.

<sup>11</sup> Id., at 134-5.

A. There is no question of doubt that a large amount of that stock was sold because people believed in me.

Q. And were also conscious of the fact that you and your group were the ones that had gotten the management stock, for virtually no cash, isn't that so? On the reliance that you people were going to operate that trust?

A. There is no question about that.

About the 25th of June 1937, Philip A. Frear commenced negotiations with Mr. Grow for the purchase of the control block of stock of the company held by Mr. Grow and his associates.<sup>12</sup> Late in July 1937, only five weeks after Mr. Grow met Mr. Frear<sup>13</sup> and without any substantial investigation of the financial status or investment ability of Mr. Frear and his associates,<sup>14</sup> Mr. Grow, on behalf of himself and his associates, contracted to sell the 25,000 shares of the Class A management stock of First Income Trading Corporation to Philip A. Frear for \$125,000. The contract provided that 20,000 shares were to be delivered on August 5, 1937, the closing date of the contract, for \$110,000, which included a \$10,000 bonus payment to Messrs. Grow and Wicks, and the remaining 5,000 shares were to be turned over a week later.<sup>15</sup> Mr. Grow and his associates also agreed to resign from the board of directors of First Income Trading Corporation so that they might be replaced by representatives of the new management.<sup>16</sup> In addition to the payment of \$125,000 for 25,000 shares of the Class A stock, it was further provided that Messrs. Wicks and Grow would receive at the time of sale additional payments of \$5,000 each and that they would be retained by the new management as technical advisers to the company for a period of three years at a salary of \$5,000 a year.<sup>17</sup>

On August 5, 1937, the day of the closing of this contract, S. Leo Solomont,<sup>18</sup> who was an attorney for Paine, Webber & Co., a nationally known brokerage firm and member of the New York Stock Exchange<sup>19</sup> had arranged with that firm to lend \$110,000, ostensibly to one of his clients,<sup>20</sup> who was later revealed to Paine, Webber & Co. to be George H. Clayton, Jr.<sup>21</sup> The loan was to be collateralized by securities contained in a list shown to Paine, Webber & Co., which

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<sup>12</sup> Id., at 141-2.

<sup>13</sup> Ibid.

<sup>14</sup> Id., at 145-6.

<sup>15</sup> Id., Commission's Exhibit No. 5. The balance of the 5,000 shares were never turned over to the Fiscal Management group. They were apparently held by persons who were not as close to Mr. Grow as those individuals whose shares were included in the 20,000 shares which were turned over to the Fiscal Management group on August 5, 1937.

<sup>16</sup> Ibid.

<sup>17</sup> Id., at 157-8.

<sup>18</sup> S. Leo Solomont was a member of the law firm of Evart and Solomont. Mr. Evart, a member of this firm, was a brother of Albert Evart, who was a partner in the firm of Paine, Webber & Co. (Id., at 165-6.) Until August 1937, Mr. Solomont was a negligible investor or trader as far as Paine, Webber & Co. was concerned and had never requested Paine, Webber & Co. to make substantial loans to any client. (Id., at 167-9.) Mr. Solomont had a small personal account with Paine, Webber & Co. (Id., Commission's Exhibit No. 7.)

<sup>19</sup> The brokerage firm of Paine, Webber & Co. has about 20 branches in about 17 states and is among the 6 largest brokerage firms in the country. (Id., at 260.)

<sup>20</sup> Id., at 169-171.

<sup>21</sup> Id., at 177.

had cost approximately \$182,500.<sup>22</sup> These securities were to be sold in the open market by Paine, Webber & Co., and the excess of the proceeds of the sale of these securities over the \$110,000, the amount of the advance, was to be "turned over to the client of Mr. Solomont."<sup>23</sup>

On August 5, the closing date of the contract, Mr. Grow testified that "we [Grow and his associates] voted ourselves out and they [the members of the Fiscal Management group] voted themselves in prior to the receipt by us of any check of any nature whatsoever."<sup>24</sup>

The new board of directors immediately authorized the sale of portfolio securities belonging to First Income Trading Corporation to George H. Clayton, Jr., a member of the Fiscal Management group. These securities were substantially the same securities included in the list originally shown to Paine, Webber & Co. upon which that firm had agreed to advance \$110,000.<sup>25</sup> The proceeds of the sale of these securities were to be used to purchase from George H. Clayton, Jr., 1,825 shares of the preferred stock of Fiscal Management Company, Ltd., at \$100 per share for a total of \$182,500.<sup>26</sup> George H. Clayton, Jr., as part of the same transaction, assigned these portfolio securities of First Income Trading Corporation to S. Leo Solomont. Mr. Solomont was directed to sell these securities in his sole discretion: to retain \$110,000 from the proceeds to pay off the loan to Paine, Webber & Co., and to return the balance to George H. Clayton, Jr.<sup>27</sup>

Simultaneously, Mr. Wicks, associated with the Grow management, removed all the portfolio securities of First Income Trading Corporation<sup>28</sup> which were in the vault, including the securities to be

<sup>22</sup> Id., at 567. The list exhibited to Paine, Webber & Co. contained the following securities: 700 shares of Consolidated Edison Company of New York; 600 shares of United Aircraft Corp.; 1,200 shares of Boeing Aircraft Co.; 200 shares of Youngstown Sheet and Tube Co.; 200 shares of Crucible Steel Company of America; 600 shares of Douglas Aircraft Company, Inc.; and "others." The credit manager of Paine, Webber & Co., to whom this list was shown, computed the value of these securities as between \$150,000 and \$160,000. (Id., at 171-2.)

<sup>23</sup> Id., at 173.

<sup>24</sup> Id., at 202. Mr. Wicks further testified with respect to this change in management as follows (id., at 221):

Q. But you had resigned from the board before you had gotten the check, isn't that so?

A. Yes.

Q. Now, before you had resigned from the board, had the Paine, Webber check been exhibited to you and then somebody said "Mr. Wicks, see, we have the money, now resign?"

A. No.

Q. You had not seen the color of their money when you resigned, is that it?

A. No.

The representatives of the Fiscal Management group on the board of First Income Trading Corporation included G. J. Mitchell, Jr., as president, John M. McKay as vice president, and L. A. Williams as treasurer. (Id., Commission's Exhibit No. 13.)

<sup>25</sup> Id., Commission's Exhibit No. 14. The resolution read as follows: "That Laurens A. Williams, Treasurer of First Income Trading Corporation, be and he is authorized to sell, set over, and transfer unto George Clayton of New York, N. Y., the following named securities: 700 Consolidated Edison Company of New York; 200 Bethlehem Steel Corporation; 1,200 Boeing Aircraft Co.; 200 Youngstown Sheet & Tube Co.; 200 Crucible Steel Company of America; 600 Douglas Aircraft Company, Inc." (Cf. note 22, supra.)

<sup>26</sup> Id., Commission's Exhibit No. 14.

<sup>27</sup> Id., Commission's Exhibit No. 27.

<sup>28</sup> Id., at 220. The securities removed from the vault constituted only a portion of the securities belonging to First Income Trading Corporation. The company also had accounts with the brokerage houses of Fenner & Beane, Sutro Bros. & Co., and Goodbody & Co. (Id., Commission's Exhibits Nos. 17, 18, and 19.)

transferred to Mr. Clayton, and turned them over directly to Paine, Webber & Co.<sup>29</sup> for the account of First Income Trading Corporation in the name of S. Leo Solomont.<sup>30</sup> In return for these securities, Paine, Webber & Co. delivered a check for \$110,000 to the order of George H. Clayton, Jr.,<sup>31</sup> who endorsed this check to Messrs. Wicks and Grow in payment for the 20,000 shares of Class A stock of First Income Trading Corporation.<sup>32</sup>

Paine, Webber & Co., immediately after the transfer to it of the portfolio securities of the First Income Trading Corporation as collateral for the loan of \$110,000, sold these securities in the open market for \$152,504.45—securities which had cost the First Income Trading Corporation \$182,500.<sup>33</sup> From these receipts Paine, Webber & Co. deducted \$110,000 in satisfaction of its advance to George H. Clayton, Jr.,<sup>34</sup> and credited \$802.69 to the personal brokerage account of S. Leo Solomont with Paine, Webber & Co. to satisfy the debit balance in that account.<sup>35</sup> The balance of the proceeds, \$41,701.76, was turned over by check to S. Leo Solomont<sup>36</sup> and was retained by the Fiscal Management group as “commissions.”<sup>37</sup> Subsequently, the balance of the brokerage account of First Income Trading Corporation with Paine, Webber & Co. was transferred to the brokerage firm of Prentice & Brady, members of the New York Stock Exchange, with which firm George H. Clayton, Jr., had long been associated.<sup>38</sup>

George H. Clayton, Jr., transferred the 20,000 shares of Class A stock of First Income Trading Corporation to Fiscal Management Company, Ltd., valued for purposes of the transfer at \$202,495.<sup>39</sup>

<sup>29</sup> Id., Commission's Exhibit No. 11. These securities included 700 shares Consolidated Edison Company of New York stock; 600 shares United Aircraft Corp.; 1,200 shares Boeing Airplane Company; 200 shares Youngstown Sheet & Tube Co.; 900 shares North American Aviation, Inc.; 200 shares Crucible Steel Company of America; 600 shares Douglas Aircraft Company, Inc.; 600 shares Western Union Telegraph Company, Inc.; 2,000 shares United Air Lines Transport Corporation; 200 shares Bethlehem Steel Corporation; 1,000 shares Electric Bond & Share; 800 shares Stone & Webster, Inc. These shares were authorized to be transferred to Paine, Webber & Co. by George J. Mitchell, Jr., the new president of First Income Trading Corporation. (Id., Commission's Exhibit No. 8.)

<sup>30</sup> Id., at 196 and Commission's Exhibit No. 12.

<sup>31</sup> Id., Commission's Exhibit No. 6. Philip A. Frear had assigned his contract to purchase the control block stock of First Income Trading Corporation to George H. Clayton, Jr., on August 4, 1937, prior to the consummation of the contract. (Id., at 615-6 and Commission's Exhibit No. 77.) Mr. Frear stated that he had represented, in these negotiations for the control of First Income Trading Corp., “an undisclosed group” and was “not a principal in the transaction”. (Id., Commission's Exhibit No. 46.)

<sup>32</sup> Id., Commission's Exhibits Nos. 6 and 15.

<sup>33</sup> Id., at 566-7.

<sup>34</sup> Ibid.

<sup>35</sup> Id., at 1676-9. Stephen Paine testified that he did not know that \$802.69 of the proceeds resulting from liquidated portfolio securities of First Income Trading Corporation had been used to wipe out the deficit balance which Mr. Solomont had with Paine, Webber & Co. (Ibid.)

<sup>36</sup> Id., at 180, 566, and Commission's Exhibit No. 9.

<sup>37</sup> Id., at 567-8, 575. Mr. Solomont received \$13,000, Mr. Frear received \$14,000, and Mr. Ferretti received \$15,000. (Id., Commission's Exhibit No. 74.)

<sup>38</sup> Id., at 582 and Commission's Exhibit No. 75.

<sup>39</sup> Letter of August 11, 1937, from George H. Clayton, Jr., to Fiscal Management Company, Ltd. (Id., Commission's Exhibit No. 64.) It will be recalled that this block of 20,000 shares of the Class A stock of First Income Trading Corporation was purchased by the Fiscal Management group for \$110,000 (Id., at 564-5.)

This transfer lodged the control of First Income Trading Corporation in the latter company. In consideration therefor, Fiscal Management Company, Ltd. issued to Mr. Clayton 1,825 shares of its preferred stock and 19,995 shares of its common stock. Mr. Clayton then transferred these 1,825 shares of the preferred stock of Fiscal Management Company, Ltd., to First Income Trading Corporation at \$100 per share for a total of \$182,500 to reimburse, on the basis of cost, First Income Trading Corporation for its portfolio securities which had been sold by the Fiscal Management group. The 19,995 shares of common stock of Fiscal Management Company, Ltd., constituting the sole outstanding voting stock of that corporation, were retained by Mr. Clayton and his associates.<sup>40</sup>

As a result of these transactions, in place of marketable portfolio securities which had cost approximately \$182,500 and had realized \$152,000 in the market, First Income Trading Corporation held 1,825 shares of the preferred stock of the newly organized Fiscal Management Company, Ltd., the personal holding company of the group, which had no assets prior to the transfer to it of the management stock of First Income Trading Corporation. Mr. Mitchell, one of the Fiscal Management group, testified:<sup>41</sup>

Q. Did you know that George Clayton was going to sell it [the preferred stock of Fiscal Management Company, Ltd.] to First Income Trading Corporation?

A. That is right.

Q. That was part of the plan, isn't that so?

A. That is right.

Q. And that is the only way you could compensate the First Income Trading Corporation for the securities which were sold out of its portfolio, isn't that so?

A. That is right.

Q. So it was your plan, from the very inception, that the control would be put in the Fiscal Management and the Fiscal Management would be the company whose preferred stock would replace the investment trust portfolio securities, isn't that so?

A. That is right.

Q. And at the time that was done, Fiscal Management had nothing, isn't that so?

A. That is correct.

The individuals in the Fiscal Management group received approximately \$42,000 in cash (the difference between the \$152,000 realized from the sale of the portfolio securities and \$110,000 repaid to Paine, Webber & Co.) as a profit or "commission"; and, in addition, they received the 19,995 shares of the common stock of Fiscal Management Company, Ltd. which constituted absolute control of that company, which in turn held the controlling block of stock of First Income Trading Corporation. This control block of stock of First

<sup>40</sup> Ibid. This letter indicates the 19,995 shares of common stock of Fiscal Management Company, Ltd., were to be issued in the following certificates: one of 10,200 shares and one of 9,795 shares and were to be delivered to George H. Clayton, Jr., in care of Vincent Ferretti. These shares were subsequently distributed between Messrs. Frear and Clayton. (Op. cit. supra, note 1, at 560-1.) Mr. Clayton actually received 10,000 shares and Mr. Ferretti. These shares were subsequently distributed between Messrs. Frear and Clayton. Clayton, Jr., transferred his block of the common stock of Fiscal Management Company, Ltd., to his personal holding company, the Northern Capital Holdings, Ltd., which he had organized on October 12, 1937. (Id., at 1594-5 and Commission's Exhibit No. 78.)

<sup>41</sup> Id., at 563-4.

Income Trading Corporation had been acquired by the Fiscal Management group through the use of \$110,000 of First Income Trading Corporation's own funds.

As a result of these transactions, the investor in First Income Trading Corporation, whose investment originally represented an interest in a diversified investment company, became a holder of securities in an investment company one-fourth of whose assets was represented by 1,825 shares of the preferred stock of Fiscal Management Company, Ltd., a holding company whose only asset, in turn, was the Class A management stock of his own company, First Income Trading Corporation.

The preferred stock of Fiscal Management Company, Ltd., was entitled on any liquidation of the company to a preference against its assets to the extent of \$100 per share and accrued unpaid dividends, and to an annual cumulative dividend of \$7 per share.<sup>42</sup> Thereafter the preferred stock shared equally with the common stockholder in any further earnings derived by the company.<sup>43</sup> However, the only asset of Fiscal Management Company, Ltd., as has been indicated, was the management stock of First Income Trading Corporation which, although it had only a fixed liquidating value of \$5,000, had a right to 25% of the earnings of First Income Trading Corporation.<sup>44</sup>

It will be recalled that between April 1933 and August 1937 the Class A management stock of First Income Trading Corporation had earned only \$16,000 in management fees.<sup>45</sup> However, the record indicates that these payments were made on the management stock under an accounting method used to determine the "profits" of First Income Trading Corporation which deserves some description. In computing "actual profits realized" no deduction or provision was made for the unrealized depreciation on the balance of the portfolio securities. Therefore, although the unrealized depreciation on the balance of the portfolio may have greatly exceeded the "realized profit" on particular securities sold, the management still considered that "profit" had been made on which it was entitled to commissions and from which dividends could be paid. Mr. Grow, when examined on accounting practices, testified:<sup>46</sup>

Q. Mr. Grow, you said that you had been paying dividends to the holders of the B stock for an appreciable period of time?

A. Yes.

Q. And your management compensation, of course, was predicated upon profits, isn't that so?

A. That is right.

Q. Now, when you computed profits first for the purpose of declaring a dividend for the payment of distribution to certificate holders, did you take into consideration the realized profits on the sales you made, or did you also set up a reserve for any unrealized depreciation that you had in your portfolio?

A. Well, we calculated on each transaction. If a block of securities was purchased and subsequently sold, that created a profit. That profit was set up on the books so much as reserve, so much to management, and so much to dividends, you see.

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<sup>42</sup> *Id.*, Commission's Exhibit No. 64.

<sup>43</sup> *Ibid.*

<sup>44</sup> See notes 6 and 7, *supra*.

<sup>45</sup> See note 8, *supra*.

<sup>46</sup> *Op. cit. supra*, note 1, at 235-9.

Q. That reserve you talk about was not the reserve for unrealized depreciation on the portfolio securities, was it?

A. It was a reserve to offset depreciation in the portfolio as well as to take care of taxes.

Q. Let me give you a situation. Suppose you sold a block of stock and you made \$10,000 profit.

A. Yes.

Q. And after you computed the market value of the securities that you had remaining in the portfolio, you had an unrealized depreciation of \$50,000. Did you consider that you had \$10,000 profit?

A. We considered that we had made a profit on that transaction.

Q. So that you were making distributions on the basis that you had made a profit on the transaction, but the fact of the matter is that at that very time you had a substantial unrealized depreciation on the balance of your portfolio, isn't that so?

A. It is possible that at times there was a depreciation in the portfolio while we were paying dividends, but indirectly from the profits.

Q. So that what you were doing during this successful period is that any time you wanted to show a profit you would sell securities which were slightly above cost and forget about the ones which were selling below cost, is that it?

A. That is not it.

Q. But that is what you were doing. You were making distributions upon which you were entitled to management fees even though the balance of the portfolio showed an unrealized depreciation, isn't that so?

A. No; that is not so. We were not an investment trust in the usual sense of the word. We were a trading corporation. Our method of operating and our method of accounting had been in vogue for four and one-half, five years—

Q. In vogue with you, you mean?

A. In vogue with the corporation.

Q. That is right?

A. That is right.

Q. That was your own peculiar system that you had?

A. Our own special system.

\* \* \* \* \*

Q. Let me first get the fact. The fact is that there were times that the profits that you had on the particular transaction did not equal the unrealized loss that you had on the balance of your portfolio; isn't that so?<sup>47</sup>

A. That is true, the same as with every corporation.

Q. But you considered that a profit?

A. Yes.

Q. From which you made payments, the distribution of dividends?

A. Yes, sir.

Q. And upon which you gave yourselves a management fee, isn't that right?

A. Yes, sir.

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<sup>47</sup> Mr. Grow answered this question despite the advice of his counsel, Mr. Reilly. With respect to this question, Mr. Grow testified as follows (id., at 238) :

Mr. SCHENKER. \* \* \* You took an unrealized loss on your portfolio even though you sold some securities at a market above what they cost you, and you considered you had a profit and you declared dividends which entitled you to a management fee.

Mr. REILLY. May I interrupt?

Mr. SCHENKER. Let him answer first.

Mr. REILLY. If what you are driving at is to have Mr. Grow admit that he paid dividends out of capital and not out of earnings considering the whole picture I will advise him not to answer on the ground of his constitutional right.

WITNESS. I'd just as soon answer that question.

Q. And were you not really paying dividends out of capital and not out of earnings?

A. No, sir.

Q. But there is no doubt in your mind that you did that; isn't that so?

A. Did what?

Q. That you considered you had profits out of which you paid dividends and paid yourself a management fee?

A. No question about that.<sup>48</sup>

Nevertheless any future increase in the salable value of the management stock of First Income Trading Corporation held by Fiscal Management Company, Ltd., which might result from an enhancement in the earnings of such management stock would redound to the benefit of the group which held all of the common stock of Fiscal Management Company, Ltd. By purposely designing Fiscal Management Company, Ltd., as a leverage company<sup>49</sup> to hold controlling blocks of the equity securities of leverage investment companies, the Fiscal Management group would acquire not only the leverage advantage of the stocks in the portfolio of Fiscal Management Company, Ltd., but would also acquire the leverage advantage of the common stock of Fiscal Management Company, Ltd. itself which it owned.<sup>50</sup> Because of its leverage advantage the common stock of Fiscal Management Company, Ltd., all of which was held by its organizers, would increase in asset value more rapidly than an increase in the value of the total assets of the company.

As a consequence of this leverage advantage in the common stock of Fiscal Management Company, Ltd. held by its organizers, any appreciation in the market value of the management stock of First Income Trading Corporation arising from increased earnings or from the control value of the stock, beyond the liquidating value of the preferred stock of Fiscal Management Company, Ltd., held by First Income Trading Corporation, would accrue entirely to the common stockholders of Fiscal Management Company, Ltd.<sup>51</sup>

On the other hand, if First Income Trading Corporation had retained the marketable securities in substitution of which it had been

<sup>48</sup> See also *id.*, Commission's Exhibits Nos. 1 and 46.

<sup>49</sup> For a general discussion of the characteristics of leverage, see Part One of this report (House Doc. No. 707, 75th Cong.), Ch. II, p. 28.

<sup>50</sup> As will be described *infra*, Fiscal Management Company, Ltd., acquired a controlling block of the common stock of Continental Securities Corporation, a leverage investment company, which in turn acquired a controlling block of the common stock of Reynolds Investing Company, Inc., another leverage investment company. The common stocks of Continental Securities Corporation and of Reynolds Investing Company, Inc., would appreciate in asset value, because of their leverage, at a greater rate than the appreciation in the value of the assets of such companies. The common stock of Fiscal Management Company, Ltd., would appreciate in asset value, because of its leverage, at a greater rate than the appreciation in the value of the common stock of Continental Securities Corporation held by Fiscal Management Company, Ltd.

<sup>51</sup> For example, assume that the management stock of First Income Trading Corporation had a value of \$110,000, the sum which the Fiscal Management group had paid for the shares. At this point the common stock of Fiscal Management Company, Ltd., had no asset value since the 1,825 shares of its preferred stock held by First Income Trading Corporation was entitled to a preference of \$182,500 against the assets of Fiscal Management Company, Ltd. However, if the value of the First Income Trading Corporation management stock tripled to \$330,000, the common stock of Fiscal Management Company, Ltd., would have increased from a minus asset value of \$72,500 to a positive asset value of \$147,500.



compelled to accept the preferred stock of Fiscal Management Company, Ltd., any appreciation in the value of such marketable securities would have accrued entirely<sup>52</sup> to the Class B stock of First Income Trading Corporation, all of which was held by the public.

Furthermore, the interownership of stock by First Income Trading Corporation and Fiscal Management Company, Ltd. would tend to create an artificial and deceptive appearance of enhancement of the assets of each company. An increase in the earnings of the management stock of First Income Trading Corporation held by Fiscal Management Company, Ltd. would presumably increase the value of such management stock. This increase in the value of the management stock would increase the earnings and the value of the assets of Fiscal Management Company, Ltd. and would thus increase the market value of the preferred stock of Fiscal Management Company, Ltd.<sup>53</sup> As a consequence, the assets of First Income Trading Corporation would increase in value as the reflection of the increase in value of the shares of preferred stock of Fiscal Management Company, Ltd., which it owned. The resultant augmented value of the assets of First Income Trading Corporation might tend to increase the market value of its management stock since the earning power of such stock might be deemed to have increased because of the increase in the total investible assets of the company. The increased market value of First Income Trading Corporation management stock held by Fiscal Management Company, Ltd., would increase the value of the assets of that company. Thus the cycle of artificial valuations which has been described would be repeated. In fact, however, the underlying values and earning power of the assets of the two companies, other than their circular ownership of each other's stock, would not have been increased in any way.

The stockholders of First Income Trading Corporation were not informed or consulted with respect to the transfer of control of the investment company by the old management to the Fiscal Management group. Despite the fact that the Class B stock had been purchased by the public in reliance on the continued management of First Income Trading Corporation by Mr. Grow and his associates, Mr. Grow did not require the Fiscal Management group to make an offer to purchase the stock held by the public. Despite the fact that the sales literature distributed by Mr. Grow and his associates emphasized the high standards of "honesty" and "integrity"<sup>54</sup> required of managers of investment companies, Mr. Grow did not hesitate to sell control of First Income Trading Corporation to persons, some of whom he had known only for about two weeks, and others whom he had met only on the closing date of the contract. Mr. Grow testified to this as follows:<sup>55</sup>

Q. And you only knew Frear two weeks; isn't that so?

A. Approximately; yes.<sup>56</sup>

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<sup>52</sup> It will be recalled that the management stock of First Income Trading Corporation was entitled to only \$5,000 on any liquidation of its assets.

<sup>53</sup> Since the preferred stock of Fiscal Management Company, Ltd., had a participating share in the entire earnings of the company, the stock on the basis of its earning power would presumably sell in the market at a price higher than its liquidating preference in assets.

<sup>54</sup> *Op. cit. supra*, note 1, at 242, and Commission's Exhibit No. 22.

<sup>55</sup> *Id.*, at 145-7.

<sup>56</sup> Mr. Grow had previously testified that he had known Mr. Frear for five weeks; see note 13, *supra*.

Q. And you only knew Ferretti two weeks?

A. Approximately.

Q. Clayton you saw for the first time in your life the day you turned over control and got the check?

A. I never knew Clayton.

Q. What are some of the big names that were mentioned to you who were going to put up this money necessary to go out and buy these various investment trusts?

A. Some very well-known names in their own communities; Mr. Boewing, of Toronto.

Q. What did you know about Mr. Boewing?

\* \* \* \* \*

A. I didn't know anything except what I was told, that he was a man of means and substance and reputation.

Q. In other words, you know nothing about him?

A. During the conversation; no.

Q. Well, go on; who else?

A. Mr. Fred Ross, of Cleveland; he was president. I believe, Vater Fan Form Corporation; I don't know.

Q. You don't even know the name of the company?

A. Mr. Ernest Dixon——

Q. I say you don't even know the name of the company?

A. I have given it to you.

Q. What did you say it was?

A. Vater Fan Form Corporation. Mr. Ernest Dixon, of Toronto, who was well known around Michigan, and a man named George Bartholomew.

Q. Tell us about George Bartholomew.

A. Well, Dr. George Bartholomew was introduced to me subsequently as a German economist associated with the German Embassy in Washington and as the man who obtained the Vaughn Bible, apparently, for Congress.

Q. You say he is the adviser to the German Embassy?

A. So I was told.

Q. You say you were told he was the adviser to the German Embassy?

A. Yes.

Q. Was he supposed to go on the board?

A. He was supposed to head it up.

Q. And Ross was supposed to go on the board; is that it?

A. That is right.

Q. And Ferretti?

A. No.

Mr. Grow took no active steps to ensure the maintenance of the investment policy of the First Income Trading Corporation for the protection of the public which had purchased the B stock upon the representation that the investment company was to have a diversified portfolio of listed securities. Although he insisted as a condition of the contract that both he and Mr. Wicks be retained as technical advisers to the company at a salary of \$5,000 a year each,<sup>57</sup> they were never consulted in this capacity. Mr. Grow testified:<sup>58</sup>

Q. You were the technical adviser, were you not, getting \$5,000 a year; what was your advice as technical adviser?

<sup>57</sup> See note 17, *supra*.

<sup>58</sup> *Op. cit. supra*, note 1, at 204 and 230.

A. My advice as technical adviser \* \* \* as we originally were employed \* \* \* that Mr. Wicks and I would supervise the operation of the income trading plan and the portfolio of the corporation, as it had been done before. I went down every day.

\* \* \* \* \*

Q. All they did was say "Hello" to you, isn't that so?

A. That's about it.

Mr. Grow and his associate, Mr. Wicks, accepted this inactivity without being suspicious, despite the fact that at the time of the transfer of control Mr. Grow orally, and on the same day in a letter, stated that Mr. Wicks and Mr. Grow were to continue on the staff of the company as technical advisers in connection with the operation of the plan, that the policies of the corporation would not be changed and that every effort would be made to maintain that same personal relationship and good faith that the corporation (First Income Trading Corporation) had built up with the stockholders for a period of years.<sup>59</sup> With respect to this statement and correspondence, Mr. Grow testified as follows:<sup>60</sup>

Q. On August 6 you were making this big speech; were you suspicious that these people were not going to maintain it after you got through negotiating with them, that you had to warn them not to change the policy?

A. No; I was not suspicious at all. Those were the terms and conditions of the change of control, that nothing would be changed.

Q. But you conferred with these people before you sold this control stock and you told them that that had been your practice, and that you had maintained the good faith and good will for these years, and you would not permit a change of that policy?

A. That is right.

Q. You told them that before you sold the stock and after you passed over control you made this big speech, is that it?

A. The speech was entered in the record of the minutes.

Q. But that represents a speech that you made?

A. Well, a statement.

Q. Now this letter is dated August 6, 1937, in which you state: "Upon turning over the management of the First Income Trading Corporation to you, we believe it is wise and proper to remind you that this corporation has been built on the spirit of intimate friendship and good faith with a large number of stockholders and in a spirit of service to them before reward to ourselves." That is precisely what you told them when you sold the stock, when you turned over the control, and now I would like to know whether you were not suspicious that they were going to do something.

A. That is not a sign of suspicion.

\* \* \* \* \*

Q. Did they come to you and ask your advice on any of this?

A. You mean after we ceased to be officers and became advisers?

Q. That is right.

A. They never asked me advice on anything, but they got voluntary advice from me.

Q. But they never came to you and said, "We want to sell." Didn't that make you a little suspicious at the time when they were paying you \$5,000 and never came to you for your expert advice?

<sup>59</sup> Id., Commission's Exhibit No. 13.

<sup>60</sup> Id., at 204, 244, and 319.

A. Not at the beginning; at the beginning it didn't.

\* \* \* \* \*

Q. Did they confer with you on this contract that called for expert advice on the portfolio?

A. No, they did not confer with me at all. There were a few days, it may have been a week or two, that Mr. Wicks and I continued trading the accounts that were in the brokerage houses in accordance with the old practices, but they gradually withdrew the securities from those accounts and suspended trading and substituted the signature cards of the people who had authorization to trade and that left us with nothing to do.

Furthermore, although Mr. Grow stated in a letter to the new management that he was selling the company on the condition that the old investment policy of the company should not be modified unless the stockholders of the company were afforded an opportunity to express themselves thereon,<sup>61</sup> the contract of sale did not contain such condition. On the contrary, the contract provided that the new management had the right to adopt immediately a new policy of investment with respect to at least 20% of the capital of the company and that after six months they could modify the investment policy with respect to the remaining 80% of the funds.<sup>62</sup> In fact, as has been indicated, as part of the transaction by which control of First Income Trading Corporation was sold, securities held by that investment company, with an approximate cost of \$182,500 (and sold for \$152,504), were liquidated and replaced with 1,825 shares of the preferred stock of Fiscal Management Company, Ltd., the personal holding company of the Fiscal Management group, which had no assets except for the control block of stock of First Income Trading Corporation.<sup>63</sup> This transaction effected a change of approximately 28% of the assets of First Income Trading Corporation.<sup>64</sup>

Thereafter approximately an additional one-fifth of the assets of First Income Trading Corporation was utilized for the benefit of Mr. Grow himself and for a company in which he was interested.<sup>65</sup>

In May 1937 Mr. Grow had registered with the Securities and Exchange Commission 250,000 shares of the Class A common stock of Barkley-Grow Aircraft Corporation.<sup>66</sup> Mr. Grow apparently was having difficulty in obtaining an underwriter for this issue of stock.<sup>67</sup> Immediately after the control of First Income Trading Corporation had been sold to the Fiscal Management group, Frear & Co. and Fiscal Management Company, Ltd., became the underwriters for this

<sup>61</sup> Id., Commission's Exhibit No. 13.

<sup>62</sup> Id., Commission's Exhibit No. 5.

<sup>63</sup> See *supra*, p. 358.

<sup>64</sup> The market value of the assets of First Income Trading Corporation amounted to \$542,634 on June 30, 1937 (excluding \$122,064 carried as deferred promotion expenses).

<sup>65</sup> In 1937, prior to the sale of the control of First Income Trading Corporation to the Fiscal Management group, Mr. Grow apparently was in need of funds. He advertised in a local newspaper soliciting financial assistance for the Trans-Lever Corporation, a company in which he was interested. (Op. cit. *supra*, note 1, at 129-30.)

<sup>66</sup> Securities and Exchange Commission, Registration Statement No. 2-3132-1.

<sup>67</sup> It was only after several amendments had been made to the registration statement that he finally procured Allison and Company, an investment banking firm, to enter into a contract to use its best efforts to distribute the securities. However, Allison and Company, between June 1937 and August 1937, had not succeeded in distributing any of these securities. (Op. cit. *supra*, note 1, at 208.)

issue of common stock of Barkley-Grow Aircraft Corporation, which involved a commitment of \$250,000.<sup>68</sup> Mr. Grow testified that he was "interested in raising money for that company,"<sup>69</sup> whose development was in a preliminary stage. When examined with respect to the status of the company as at August 5, 1937, Mr. Grow testified:<sup>70</sup>

Q. What was its point of development on August 5, 1937?

A. Its point of development on August 5, 1937, was that by that time a certain amount of capital had been raised, a plant had been acquired, machinery installed, and a crew of men had been assembled, an airplane had been designed and was in the process of being finished. I believe by that time it had been flown, although I am not quite sure of that, and five other airplanes were in the process of being constructed in anticipation of the aircraft industry of the world, and it was hoped that by the end of the year orders would be received for those planes.

First Income Trading Corporation was caused to purchase one-half of the Barkley-Grow Aircraft Corporation issue for \$125,000, thus supplying one-half of the capital which Mr. Grow required for this company.<sup>71</sup> Mr. Grow testified that he did not know until March 1938, approximately eight months later, that First Income Trading Corporation had purchased any stock in Barkley-Grow Aircraft Corporation,<sup>72</sup> despite the fact that he was closely associated with the Barkley-Grow Aircraft Corporation and had been retained, as has been indicated, as a technical adviser to the investment company at a salary of \$5,000 a year.<sup>73</sup>

In addition, immediately after Mr. Grow transferred control of First Income Trading Corporation to the Fiscal Management group,

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<sup>68</sup> Op. cit. supra, note 1, at 209 and Commission's Exhibit No. 64 (letter of August 23, 1937, from Fiscal Management Company, Ltd., to Barkley-Grow Aircraft Corporation in which Fiscal Management Company, Ltd., undertook to purchase the 250,000 shares of common stock of Barkley-Grow Aircraft Corporation for a total of \$205,000 or at 85¢ per share, and to sell these shares at \$1.00 per share).

<sup>69</sup> Id., at 207.

<sup>70</sup> Id., at 244-5.

<sup>71</sup> Id., at 568-9. According to the testimony of George J. Mitchell, Jr., one of the Fiscal Management group, the Barkley-Grow Aircraft Corporation was first underwritten by Calmur & Company, Inc., a dummy corporation which had no assets and merely constituted a vehicle to effect transactions for the Fiscal Management group. Calmur & Company, Inc., had been organized in the middle of August 1937 by Vincent E. Ferretti, and James Callanan was designated as its president. It had no assets and was originally organized to market the stock of Barkley-Grow Aircraft Corporation. (Id., at 1548-51.) Thereafter, whenever Calmur & Company needed funds it obtained assistance from First Income Trading Corporation. (Id., at 579.) The commitment of Calmur & Company to underwrite the stock of Barkley-Grow Aircraft Corporation was assigned to Fiscal Management Company, Ltd., on August 23, 1937, 18 days after the Fiscal Management group acquired control of First Income Trading Corporation. (Id., Commission's Exhibit No. 64.) Fiscal Management Company, Ltd., also had no assets, except the controlling block of stock of First Income Trading Corporation. Accordingly, First Income Trading Corporation advanced \$125,000 to Calmur & Company to take up its commitment, and First Income Trading Corporation received as collateral for this advance the 125,000 shares of the Class A stock of Barkley-Grow Aircraft Corporation. (Id., at 1551.) The balance of the commitment was taken up by Continental Securities Corporation, another investment company, control of which was subsequently acquired by the Fiscal Management group. (See infra, pp. 377 and 407.)

<sup>72</sup> Op. cit. supra, note 1, at 205-210. Significantly, however, Mr. Grow himself contacted Mr. Frear even prior to the consummation of the contract providing for the transfer of control of First Income Trading Corporation, to discuss the possibility of obtaining an underwriter for the Barkley-Grow Aircraft Corporation, and was aware of the fact that subsequently Fiscal Management Company, Ltd., became its underwriter. (Ibid.)

<sup>73</sup> Id., Commission's Exhibit No. 5. See supra, pp. 365-6.

Mr. Ferretti, a member of that group, lent \$10,000 to Mr. Grow, receiving as collateral security an assignment of Mr. Grow's personal account with Goodbody & Co., a brokerage firm.<sup>74</sup> This \$10,000 was evidently supplied by First Income Trading Corporation.<sup>75</sup> Subsequently, Mr. Grow's account with Goodbody & Co. became undermargined and Mr. Ferretti transferred, with the consent and knowledge of Mr. Grow,<sup>76</sup> 200 shares of Western Union stock from the portfolio of First Income Trading Corporation, valued at \$6,600, to this personal account of Mr. Grow.<sup>77</sup> This sum of \$6,600 was never repaid to First Income Trading Corporation,<sup>78</sup> nor did Mr. Grow ever repay the \$10,000 which he borrowed from First Income Trading Corporation through Mr. Ferretti.<sup>79</sup>

To recapitulate the sums paid to Mr. Grow, his airplane company, and his associates: \$100,000 was paid out of the funds of First Income Trading Corporation to Mr. Grow and his associates for their management stock; \$125,000 of the funds of the investment company was used to purchase Barkley-Grow Aircraft Corporation stock; \$10,000 of the company's funds was advanced to Mr. Grow; portfolio securities valued at \$6,600 were put into Mr. Grow's personal brokerage account; \$10,000 "extra" payments were made by the company to Mr. Grow and his associate Mr. Wicks under the agreement transferring control; and approximately \$5,000 of the company's funds was paid to Messrs. Wicks and Grow as technical advisers to the investment company. Thus, a total of \$256,600 of the funds of First Income Trading Corporation was paid out either directly to Mr. Grow and his associates or to companies in which Mr. Grow was interested. There is no evidence that any of these payments to Mr. Grow and his associates were disclosed to the stockholders of First Income Trading Corporation, although as a result thereof practically 47% of the assets of First Income Trading Corporation had been used for the benefit of Mr. Grow and his associates. These payments were made by

<sup>74</sup> Op. cit. supra, note 1, at 210-2.

<sup>75</sup> Mr. Callanan, one of Mr. Ferretti's associates (id., at 1523-4), testified as follows with respect to the extent to which First Income Trading Corporation supplied funds to Mr. Ferretti (id., at 1552-4):

Q. Now, anytime Ferretti needed money he would borrow from First Income Trading Corporation through Calmur, isn't that so?

A. I presume that was right.

Q. Those were personal loans?

A. For legal fees.

Q. Legal fees?

A. At least they were entered as that.

Q. What?

A. At least they were entered as that.

Q. They were entered on the books of First Income Trading Corporation?

A. On the check books of Calmur & Company.

Q. Calmur & Company had no books, all it had is a check book?

A. Yes.

Q. And all the bookkeeping was done on the stub?

A. Yes.

Q. Ferretti was not a practicing lawyer, was he?

A. No, sir.

Q. Yet the entries on the stub used to be for legal fees for Ferretti, is that it?

A. For one of those, which I recall.

Q. Were you supposed to get your cut in those fees too?

A. No, sir.

Q. Did he just clear his fees through Calmur, the money that used to come in the form of fees to Ferretti, and he would draw it out, is that it?

A. I suppose that was it.

<sup>76</sup> Op. cit. supra, note 1, at 211-3.

<sup>77</sup> Id., at 211-3, 570-1.

<sup>78</sup> Id., at 571.

<sup>79</sup> Id., at 211.

the investment company, the investment policy of which Messrs. Grow and Wicks were to supervise as technical advisers of the company.

A large part of the remaining assets of First Income Trading Corporation was used to purchase practically worthless securities which were recommended by George H. Clayton, Jr., another member of the Fiscal Management group. An investment of \$61,225 was made in stock of the Red Bank Oil Corporation, which was guaranteed by Calmur & Company, Inc.,<sup>80</sup> the "dummy" corporation without any assets, organized as indicated above by Vincent E. Ferretti, a member of the Fiscal Management group and James Callanan.<sup>81</sup> The value of this investment subsequently depreciated to \$19,000.<sup>82</sup> The Red Bank Oil stock was then transferred to Calmur & Company, Inc., as agent, to sell this stock and remit the proceeds to the investment company.<sup>83</sup> Calmur & Company, Inc. sold this stock for \$19,000 but paid over only \$9,000 to First Income Trading Corporation and never fulfilled its obligation to guarantee the investment company against the loss on the original investment of \$61,225.<sup>84</sup> First Income Trading Corporation was caused to invest an additional sum of \$10,000 in 30,000 shares of Cook Lake Gold Mines, Ltd., which investment was also guaranteed by Calmur & Company, Inc.<sup>85</sup> However, Calmur & Company, Inc. failed to meet its guarantee on this obligation also.<sup>86</sup> On the recommendation of George H. Clayton, Jr., \$37,350 was invested in 150,000 shares of the preferred stock of Laclede Gas Company.<sup>87</sup> First Income Trading Corporation also at this time was caused to make an unsecured loan to Fireless Cooker Company,<sup>88</sup> in the amount of \$10,000, and an unsecured loan to Dr. Bartholemew.<sup>89</sup> Up to the time of the public examination neither of these loans had been repaid.

In addition to these transactions, the funds of First Income Trading Corporation were used to facilitate the program of acquisition of control of other investment companies by the Fiscal Management group. In January 1938, First Income Trading Corporation was caused to purchase 108,755 shares of the common stock of Reynolds Investing Company, Inc., for \$217,000.<sup>90</sup>

<sup>80</sup> Originally this investment was purchased by Calmur & Company, Inc., which "did not have a dime," and was subsequently transferred to First Income Trading Corporation. (Op. cit. supra, note 1, at 571-2 and Commission's Exhibit No. 73.) See also note 71, supra.

<sup>81</sup> See note 71, supra.

<sup>82</sup> Op. cit. supra, note 1, at 572.

<sup>83</sup> Id., at 572-3.

<sup>84</sup> Ibid. and Commission's Exhibit No. 73.

<sup>85</sup> Id., at 576.

<sup>86</sup> Id., at 578.

<sup>87</sup> Ibid. Similarly, First Income Trading Corporation was compelled to invest \$7,000 in 500 shares of the preferred stock of South American Utilities Corporation (id. at 578), an investment which was made in order to aid Alexander B. Beverly, who was also a member of the Fiscal Management group, in acquiring a controlling interest in South American Utilities Corporation. (See infra, pp. 399-406.)

<sup>88</sup> Op. cit. supra, note 1, at 579.

<sup>89</sup> Id., at 579, 589. According to Mr. Grow's testimony, Dr. Bartholemew was introduced to Mr. Grow as a "German economist associated with the German Embassy in Washington," who was supposed to become chairman of the board of First Income Trading Corporation. (Id., at 146.)

<sup>90</sup> Id., at 579 and Commission's Exhibit No. 75. Of this amount, \$182,500 had been raised by First Income Trading Corporation from the sale by it to Continental Securities Corp. of the 1,825 shares of preferred stock of Fiscal Management Company, Ltd., which had originally been sold by the group to First Income Trading Corporation. (Id., at 580.)

During the seven-month period from August 1937 to March 1938, when the Fiscal Management group controlled First Income Trading Corporation, the assets of that investment company, consisting largely of marketable securities with a value of over \$500,000, were depleted. Approximately \$80,000 was virtually dissipated in purchasing stock of Red Bank Oil Corporation, Cook Lake Gold Mines, Ltd. (whose shares were of doubtful value) and in making an advance to Fireless Cooker Company; the sum of \$125,000 was used to purchase Barkley-Grow Aircraft Corporation stock: approximately \$25,000 was paid to Mr. Grow and/or his associates in the form of loans and salary payments; the sum of \$217,000 was used to purchase 108,755 shares of common stock of Reynolds Investing Company, Inc., which went into reorganization under Section 77B of the Bankruptcy Act in May 1938; and \$41,000 was appropriated by the Fiscal Management group as "commission" and "profits." The Michigan Securities Commissioner has taken over First Income Trading Corporation for liquidation.<sup>91</sup>

### 3. ACQUISITION OF CONTROL OF CONTINENTAL SECURITIES CORPORATION

In October 1937, after an abortive attempt to acquire control of Insuranshares Corporation of Delaware (an investment company)<sup>92</sup> the Fiscal Management group acquired control of Continental Securities Corporation, an investment company with then total assets of \$3,300,000.

Continental Securities Corporation had been organized on March 19, 1931 under the laws of Maryland and was sponsored by J. Henry Schroder Banking Corporation; Clark, Dodge & Co.; Brown Bros. & Co. (now known as Brown Bros., Harriman & Co.); and Lee Higginson & Co. It was a consolidation of Continental Securities Corporation (old) which had been organized in December 1924 and Continental Holding Corporation which had been organized in December 1930.<sup>93</sup>

Continental Securities Corporation had authorized the issuance of debentures with a face value of \$5,000,000, 50,000 shares of \$5 cumulative preferred stock with a par value of \$100, which was entitled to \$100 and accrued dividends on liquidation of the company, and 100,000 shares of \$5 par value common stock which had the sole voting power.<sup>94</sup>

Continental Securities Corporation had originally raised approximately \$11,250,000, of which \$5,000,000 was raised by the sale to the public of debentures with attached warrants,<sup>95</sup> \$1,500,000 from the preferred stock,<sup>96</sup> \$2,750,000 from the common stock,<sup>97</sup> and approxi-

<sup>91</sup> *Id.*, at 218.

<sup>92</sup> See *infra*, pp. 443-4.

<sup>93</sup> *Op. cit. supra*, note 1, at 419 and Commission's Exhibits Nos. 61 and 62.

<sup>94</sup> *Id.*, at 464-5 and Commission's Exhibit No. 61.

<sup>95</sup> *Id.*, at 462, 464.

<sup>96</sup> See *infra*, pp. 443-4.

<sup>97</sup> *Ibid.*



mately \$2,000,000 from the sale of units of common and preferred stock.<sup>98</sup>

Between March 1931 and October 1937, Continental Securities Corporation returned to its security holders by way of repurchases and dividends a total of approximately \$5,000,000.<sup>99</sup> As at October 25, 1937, the net capital investment was therefore approximately \$6,250,000. At the same date, however, the company had net assets of approximately \$3,300,000.<sup>100</sup> In other words, the company in its operation to 1937 had suffered a realized and unrealized loss of approximately \$3,000,000.

As at October 25, 1937, Continental Securities Corporation had outstanding debentures with a face value of \$2,778,000; 14,025 shares of preferred stock entitled to \$100 per share on liquidation; and in addition accrued unpaid dividends of \$27 per share, or a total of \$1,781,175; and 57,759 shares of common stock. Since the market value of the assets of the company was only \$3,300,000 and the debentures were entitled to \$2,778,000, only \$522,000 of assets remained for the preferred stock, which was entitled to \$1,781,175. In other words, the outstanding preferred was under water \$1,259,175, or approximately \$90 per share. Thus the assets of the company would have had to increase more than \$1,259,175 before they would have been sufficient to cover the liquidating value of the preferred stock and before the common stock would have had any asset value. The common stock, therefore, had a minus asset value of approximately \$22 a share.

Mr. Beal testified:<sup>101</sup>

Q. \* \* \* so that the preferred stock was \$50 [sic; \$63] under water on October 25, 1937, and by under water we mean that if the corporation was going to be liquidated and there was going to be a distribution to shareholders equally dollar for dollar, the preferred stockholders, and there were hundreds of them, would only get \$50 [sic; \$37] per share of preferred stock; isn't that so?

A. Yes.

Q. And that meant that the common stockholder was minus \$50 [sic; \$63] because the assets of the trust would have to increase sufficiently to make up the \$50 [sic; \$63] for the preferred stock before the common stock would be worth nothing; isn't that so?

A. There was that amount of money that had to be recovered in the preferred to bring it up to par.

Q. So that the assets of the trust would have to recoup an amount sufficient to earn \$50 [sic; \$63] on every share of the preferred before the common stock would have no asset value on liquidation; isn't that so?

A. That is correct, on that date.

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<sup>98</sup> Id., at 465. The preferred and common stock had originally been placed privately, but subsequently were publicly distributed through the New York Curb Exchange and the Boston Stock Exchange. As of October 1, 1937, Continental Securities Corporation had approximately 300 preferred and 500 common stockholders.

<sup>99</sup> Id., Commission's Exhibit No. 64. The company repurchased debentures with a face value of \$2,220,000 for an aggregate of \$1,000,000. (Id., at 460.) The debenture holders who sold their debentures thus suffered a loss of \$1,222,000, measured by the difference between the principal amount of the debentures and the sum which they received for the debentures which were repurchased by the company.

<sup>100</sup> Id., at 467.

<sup>101</sup> Id., at 470-1.

Q. Now, is that \$50 [sic; \$63] exclusive of the \$27 that the preferred was in arrears on the dividends?

A. Correct.

Q. So, therefore, on liquidation the preferred stockholder would not only be entitled to his \$100 but he would be entitled to his dividends that were passed, so that the preferred stock was really \$77 [sic; \$90] under water, wasn't it, on October 25, 1937?

A. That is correct.

Q. And the assets of the trust would have to come back in an amount sufficient to give each preferred stockholder \* \* \* \$77 [sic; \$90] before the common stock would still be worth nothing; isn't that so?

A. That is right.

As at October 25, 1937, J. Henry Schroder Banking Corporation, the sponsor of Continental Securities Corporation, owned 26,000 shares, or 44%, of the outstanding common stock of Continental Securities Corporation,<sup>102</sup> which it had acquired in the open market between 1931 and 1934 at a cost of \$430,000.<sup>103</sup> As has been indicated, this common stock had a minus asset value of about \$22 per share. In addition, J. Henry Schroder Banking Corporation held the management contract with Continental Securities Corporation.<sup>104</sup> Furthermore, General Beal, president of J. Henry Schroder Banking Corporation, was president of the investment company and was one of the seven directors on the board of Continental Securities Corporation.<sup>105</sup>

Mr. Beal conceded that the facts that the investment banking firm, J. Henry Schroder Banking Corporation, had sponsored the Continental Securities Corporation, had distributed the securities of the investment company to the public, owned a controlling block of the stock of the investment company, were represented on the directorate of the investment company, created in each such capacity a fiduciary relationship between the investment banking firm and the debenture holders, the preferred stockholders, and the minority common shareholders of the investment company, particularly to the senior security holders who would have been entitled to all the assets of the investment company upon liquidation.

Mr. Beal, when examined on the nature of the obligations of the J. Henry Schroder Banking Corporation to the other security holders of the investment company, testified:<sup>106</sup>

Q. Let me ask you this question: When your name appeared on the circular offering the \$5,000,000 of debentures as one of the underwriters of the debentures, did you feel that that imposed any obligation upon J. Henry Schroder Banking Corporation with respect to the people who purchased these debentures?

A. Yes, sir.

<sup>102</sup> Id., at 435, 477.

<sup>103</sup> Id., at 435-7.

<sup>104</sup> Id., at 427-31.

<sup>105</sup> The seven directors were G. F. Beal (J. Henry Schroder Banking Corporation); G. B. Clark (Clark Dodge & Co.); Donald Durant (Cassatt & Co., Inc.); John McHugh (Discount Corporation of New York); Ray Morris (Brown Brothers, Harriman & Co.); J. M. Miller-Aichholz (Prudential Investors, Inc.); and C. P. Fuller (J. Henry Schroder Banking Corporation). (*Moody's Manual of Investments, Banks, etc.*, 1937, p. 1086.)

<sup>106</sup> Op. cit. supra, note 1, at 422-8, 431-5.

Q. What did you conceive the obligation or the duty of J. Henry Schroder was to the people who were buying debentures which were sponsored, issued, and distributed by the Corporation?

A. Well, the usual responsibilities of any issuing house—to see that the affairs of the company were run in a reasonably honest and efficient manner.

Q. So that in connection with your distribution of the \$5,000,000 of debentures to the American public you were not unmindful of the duty that was imposed, and which the investment bankers claimed is imposed upon them, not only to passively see that nothing is done to hurt the corporation and thereby impair the value of the bonds but an affirmative duty to see that the affairs of the corporation were adequately and properly run so that no injury was done to the debenture holders. In fact, that their investment should be a good one: isn't that so?

A. Yes; I think that is correct.

Q. And it is the duty of the distributor, according to the bankers, to obtain representation on the board of directors of the corporations whose securities they are selling to the public: isn't that so?

A. I think that is so; yes.

\* \* \* \* \*

Q. But aside from your duty as a distributor, did you feel you had a duty as the sponsor—you can conceive of a situation, can you not, Mr. Beal, where you were sponsor of an investment trust although you don't distribute the securities which are put out to the public as an investment—

A. As one of the sponsors; correct.

Q. As one of the sponsors?

A. Yes.

Q. And, as a sponsoring company, did you feel that it imposed any duty or obligation on J. Henry Schroder with respect to the security holders, particularly the debenture holders of Continental Securities Corporation?

A. Yes.

Q. So that there was a duty upon you as the sponsor of this investment trust to see that nothing was done to hurt the security holders of that corporation; isn't that so?

A. Yes.

Q. There was a duty on you as distributor of the securities, the \$5,000,000 that you sold to the American public, on which you got a gross underwriting commission of \$200,000, to see that nothing was done to hurt those security holders: isn't that so?

A. Yes.

\* \* \* \* \*

Q. So that besides being one of the sponsors or organizers in conjunction with the other organizers, you sat down and gave J. Henry Schroder [Banking Corporation] a management contract: isn't that so?

A. Correct.

Q. The debenture holders \* \* \* never approved the contract formally; isn't that so?

A. No; the debenture holders did not; no.

Q. When they sold the debentures to the public, the management contract was already there: isn't that so?

A. Yes.

Q. And it continued on after they bought the debenture; isn't that so?

A. Yes.

\* \* \* \* \*

Q. Did you feel that by virtue of your having that status, of sponsor and manager of the trust, it imposed any obligation upon you with respect to the security holders of the corporation?

A. Yes.

Q. There is no doubt about that, is there?

A. No.

Q. So that we see you had a duty as sponsor, you had a duty as distributor, you had a duty as the manager. Now, were any of the principal stockholders or persons associated with the Schroder Banking Corporation officers of the Continental Securities Corporation?

A. Yes; I was.

Q. Anybody else?

A. Yes.

Q. Who else?

A. There were several others, Mr. Boyd.

Q. You were president, is that it?

A. I was president.

Q. At the time we are talking about what other persons associated with J. Henry Schroder Banking Corporation were officers of the Continental Securities Corporation?

A. Mr. Boyd, Mr. Hager, Mr. Miller, and there were several assistant secretaries who helped carry on the routine and that sort of thing.

\* \* \* \* \*

Q. And as president did you feel you had an obligation or duty to the security holders of Continental Securities Corporation?

A. Yes.

\* \* \* \* \*

Q. How many directors were there altogether?

A. Six.

Q. You had one of six; is that it?

A. Yes.

Q. And he was the Schroder man who was on the board.

A. Yes.

Q. There is no doubt that there was some obligation on Schroder by virtue of his presence on the Board of Directors; isn't that right?

A. Yes.

Q. So that there were these duties on part of Schroeder because you were the sponsor and distributor, you were the manager, you had a member on the board; there are four obligations anyway, isn't that so?

A. Yes.

Q. Now, did the Schroder group have any common stock in the Continental Securities Corporation at the time we are talking about?

A. Yes.

Q. How big a block of stock did they have?

A. About 26,000 shares.

Q. And what percentage of the total outstanding of the common was that?

A. Something over 40 percent.

Q. Over 40 percent.

A. Yes.

Q. You were by far the largest stockholder, were you not?

A. Yes.

Q. Although that was not legal control, it was actual control of the company, was it not?

A. Well, it was substantial control; yes.

Q. And you do not deny, do you, Mr. Beal, that that imposed some obligation on you people who had this control with respect to the stockholders of that company and with respect to the debenture holders, do you?

A. No.

On September 30, 1937, Lansing MacVickar, "a professional finder" purporting to represent one Alexander Beverly, a member of the Fiscal Management group, approached Mr. Beal to ascertain whether J. Henry Schroder Banking Corporation was willing to sell its controlling block of the common stock of Continental Securities Corporation. Mr. Beal testified that he caused an investigation to be made of the financial responsibility and integrity of Alexander Beverly and received reports that he "had started out in Toronto as a maker of phonographs": that he "had done very well at that; that he made quite a bit of money"; that Mr. Beverly's net worth was around "a half million dollars to as high as a million dollars at various times."<sup>107</sup>

Mr. Beal made no investigation of Fiscal Management Company, Ltd., although during the course of the negotiations Mr. Beverly, who had met with Mr. Beal, indicated that Fiscal Management Company, Ltd. (in which he stated he owned a substantial controlling interest<sup>108</sup>) was to be the purchaser of common stock of Continental Securities Corporation from the Schroder interests. Mr. Beal testified:<sup>109</sup>

A. \* \* \* Then we said, "Well, now, what exactly is your position going to be in this?" And Mr. Beverly said, "I own the controlling interest in—a very, very substantially controlling interest in a company called The Fiscal Management [Company, Ltd.], and the Fiscal Management [Company, Ltd.] will buy the Continental Securities Corporation shares. \* \* \* He mentioned the names of Mr. Frear and Mr. Ross and two associates interested in this. We said, "Are you going to be the man who will control Fiscal Management yourself, and through Fiscal Management control Continental"—

Q. Let me ask you, did he tell you that he owned the controlling stock, or did he tell you that he had the controlling stock tied up for two years?

A. He gave us every impression that he owned the controlling stock of Fiscal Management.

Q. But he did not give you the impression that it was a personal holding company of his, and that he was a substantial stockholder?

A. That there were other stockholders; there was no question about the complete control being in his hands. I might mention that Mr. Frear he mentioned was Mr. James Frear and not Mr. Philip Frear.

Q. Did you ask him who Mr. James Frear was?

A. Yes.

Q. What did he tell you?

A. That he was an ex-congressman from Wisconsin.

Q. And that was sufficient to satisfy you as to his capability or right to get \$3,300,000 of other people's money?

A. No, sir.

<sup>107</sup> Op. cit. supra, note 1, at 480-3.

<sup>108</sup> Id., at 486. Actually the controlling block of stock of Fiscal Management Company, Ltd., was held by Messrs. Clayton, Ferretti, and Frear. See note 40, supra.

<sup>109</sup> Op. cit. supra, note 1, at 486.

Q. Did you stop to find out who Mr. James Frear was?

A. No; because we were interested in Mr. Beverly.

Q. He was the one who was trying to put up a half a million dollars, approximately, and buy the securities; is that it?

A. That is it; not that Mr. Beverly was going to buy 100% of the stock, but that he was going to have a very substantial controlling interest.

Q. In the block he was buying from you, is that it?

A. That is right.

Q. You did not ask for the same information that Mr. Steele Mitchell did and say, "I don't want the names, I want to know how much each one is going to put in and who they are."

A. No; we relied entirely on Beverly.

Q. And that is the Mr. Beverly whom you had never heard of before in your life, isn't that so, until the name was mentioned to you, isn't that so?

A. That is correct.

Q. You had never spoken to him before in your life except that day when you said you wanted to talk to him, isn't that so?

A. Yes; \* \* \*

Q. But there is no doubt in your mind now, you say, that you were placing your complete faith and reliance on Mr. Beverly, and Mr. Beverly was the individual whom you never heard of before in your life and saw for the first time in your life that day when you spoke to him, isn't that so?

A. I would like to make it quite clear that we did not place our final reliance on him to the extent of going through with the business until we were completely satisfied as to Mr. Beverly.

Q. Did you check Fiscal Management [Company, Ltd.], send up to Canada to find out what that was all about?

A. We made no specific check on Fiscal Management [Company, Ltd.]. There again we relied upon Mr. Beverly in our talk.

On October 25, 1937, Mr. Beal, on behalf of J. Henry Schroder Banking Corporation, contracted to sell to Fiscal Management Company, Ltd. (described by Mr. Beverly as his personal holding company), its block of common stock of Continental Securities Corporation for \$20 a share,<sup>110</sup> out of which the Schroder interests agreed to pay \$1.30 per share as commission to Mr. MacVickar.<sup>111</sup> The contract called for the sale of 29,000 shares<sup>112</sup> of the common stock of Continental Securities Corporation for a total of \$580,000.<sup>113</sup> This block constituted an absolute majority control block of stock of the investment company, which then had assets of \$3,300,000. Of this block, 26,000 shares came from J. Henry Schroder Banking Corporation, which received a gross of \$520,000 for their shares which had cost them a total of \$430,000,<sup>114</sup> but which at that time had a minus asset value of about \$572,000.

<sup>110</sup> Id., at 490-1 and Commission's Exhibit No. 64.

<sup>111</sup> Id., at 490.

<sup>112</sup> Since the Schroder interests held only 26,545 shares of the stock (id., Commission's Exhibit No. 65), they were required to purchase the balance of 2,455 shares from some of their clients to make up this block of 29,000 shares. (Id., at 477, 929-32.) Burr & Co. bought a block of shares in the market as broker for J. Henry Schroder Banking Corporation at a cost of between \$8 or \$9 a share, which were ultimately sold by J. Henry Schroder Banking Corporation to the Fiscal Management group for \$20 a share. (Id., at 856.)

<sup>113</sup> Id., at 490-1.

<sup>114</sup> See note 103, supra.

On October 25, 1937 a check for \$580,000 drawn by Paine, Webber & Co. was delivered to Mr. Beal, and the Fiscal Management group acquired the control block of the common stock of Continental Securities Corporation. The source from which the Fiscal Management group obtained these funds necessary to effect the purchase will be described later. The representatives of the old management resigned and their places were taken by nominees of the Fiscal Management group.<sup>115</sup> Thus, J. Henry Schroder Banking Corporation, which was conceded by Mr. Beal to occupy, because of the various capacities in which it was associated with the investment company, a high fiduciary relationship to the investment company, the debenture holders, the preferred stockholders, and the minority common stockholders, turned over to the new interests control of the investment company and its \$3,300,000 of assets which "belonged" substantially to the senior security holders. Mr. Beal conceded that, had the investment company been liquidated at that time, all of its assets would have been distributed to the debenture holders and preferred stockholders, and that the common stockholders, including the holders of the controlling block of common stock, would have had no equity.<sup>116</sup>

Q. In any event, \* \* \* aside from the legal fact that the consent of the common stockholders was needed to liquidate that company, if that company was liquidated at that time the common stockholders would not have gotten a nickel. Isn't that so?

A. That is correct.

Q. Every dollar of that \$3,000,000 odd belonged to the debenture holders and the preferred stockholders. Isn't that so?

A. Yes, sir.

Q. And so far as the block of the 26,000 shares were concerned, if the company were liquidated you would not have gotten a nickel from the company for your 26,000 shares, isn't that so?

A. Yes.

Mr. Beal took no steps to inform the security holders of Continental Securities Corporation that control of their assets was to be transferred to a new group. Mr. Beal testified:<sup>117</sup>

Q. Did you say to Mr. Beverly, "Well, after all my debenture holders, my preferred stockholders, and my common stockholders think that I am in charge of and in control of the management of their \$3,300,000. I think I will have to write to my stockholders to ask them whether they want to be turned over to Mr. Beverly"; did you say that to Mr. Beverly?

A. We didn't say that to Mr. Beverly.

Q. But you talked over the matter \* \* \*.

A. I would like to mention that we did, of course, make it prerequisite to the business that the Fiscal Management should advise all the stockholders that the change of ownership had taken place \* \* \*.

Q. That was after the control had passed?

A. That is correct.

Q. And many things could happen pretty quickly, as you found out, after control had passed; isn't that so?

A. Yes.

<sup>115</sup> The technique used in replacing the directorate without calling a meeting of the stockholders will be described hereinafter.

<sup>116</sup> Op. cit. supra, note 1, at 476-7.

<sup>117</sup> Id., at 496-9.

Q. But before you turned over the other people's money to Mr. Beverly, whom you personally believed to be a reputable man, you did not write a letter to any security holders or make any public announcement that you contemplated turning over the money that belonged to them, to be run by Mr. Beverly; isn't that so?

A. That is right.

Q. You can visualize that he [Mr. Beverly] can be the highest class person in the world, can't you, Mr. Beal, and the stockholders might still say, "I want Mr. Beal to manage my money; I feel comfortable and safe with Mr. Beal of the Schroder Banking Corporation, who is a person with expert management knowledge, and while Mr. Beverly is the highest class man in the world, I don't know him. He has millions of dollars; but I invested my money with Mr. Beal and I want him to manage it." You can visualize that situation, can't you?

A. Well, I want to make it quite clear again that we were satisfied with Mr. Beverly not only because of our investigation, but also because we had gotten so many good checks from what we considered first class people, that the idea that there was anything wrong about Mr. Beverly did not exist in our minds.

Q. I am assuming that I am a stockholder, and I have the same information on Mr. Beverly. You can still visualize that situation, that while Mr. Beverly is the highest-class man in the world, I might not want Mr. Beverly to handle my money. You can conceive of that attitude; isn't that so?

A. Yes; I can see that.

Q. And you did not write to the stockholders and ask them whether it was all right for you to turn over the control of their funds to Mr. Beverly, no matter how high class he was, did you?

A. No.

Q. And you made no public announcement that you contemplated doing that, did you?

A. No.

\* \* \* \* \*

Q. Now, after October 25th, when you turned over your 29,000 shares, the debenture holders, preferred stockholders, and the minority common-stock holders went to bed thinking that you controlled the money, and the next morning woke up to find that Mr. Beverly had control of the money, isn't that so?

A. It was a very short time after that they were all notified that the change had taken place.

Q. A short time, but long enough for things to happen; isn't that so?

A. Yes.

Allen W. Dulles, of Sullivan & Cromwell, attorneys for Mr. Beal, during the negotiations for the sale of the controlling block of stock, testified it would have constituted an unusual procedure to notify the stockholders of an investment company of a contemplated transfer of control. He testified:<sup>118</sup>

Q. I assume you heard Mr. Beal's testimony with respect to the fact that there was no public announcement and no announcement sent to the stockholders apprising them of the fact that the control was going to pass prior to the time that the control actually did pass?

A. An announcement was sent immediately afterwards.

Q. Had you discussed that aspect with Mr. Beal?

A. We had.

<sup>118</sup> Id., at 1662-4.



Q. What did you say to him, and what did he say to you?

A. We insisted as part of the agreement that all security holders, stockholders, and also, as far as possible, the debenture holders should be immediately informed publicly of the change of the management, and that a statement would be inserted in the press immediately of the change of management. It was done.

Q. Subsequent to the transfer of control?

A. Immediately after the transfer of control.

Q. I am talking about prior.

A. No. I think it would be unusual to give such a notice prior to the transfer. But it was not done.

Q. I am not holding you responsible for this. It may be a trifle simple, or maybe my analysis is all wrong, but throughout this entire investigation it seems to me that the things which were done for the protection or for the benefit of the controlling interests are the usual things, and the things that might possibly be for the protection of the minority stockholders are the unusual things. Is that true? There was nothing unusual about cleaning out the board of directors through the device of resigning and electing, yet it was unusual to tell the minority stockholders and the senior security holders that their money was going to be turned over to a new manager. Isn't that so?

A. No; I do not say that. I say I think it would be unusual so far as the present practice is concerned. Maybe that should be done. That may be one of the points that your investigation will disclose.

Despite the fact that the common stock of Continental Securities Corporation had a minus asset value, Mr. Beal testified that the price of \$20 a share paid by Mr. Beverly did not create any suspicion in his mind that it may have been the intention of the Fiscal Management group to recoup their investment in some way at the expense of the other security holders of Continental Securities Corporation. Mr. Beal testified:<sup>119</sup>

First of all I asked Mr. Beverly why it was that he was interested in buying this stock and why he was interested in paying a very substantial premium for the break-up value. Mr. Beverly said, first of all, he had capital, and was interested in investment management and he wanted to buy a controlling interest in an investment trust. He said that in the second place that he realized—that in Continental Securities Corporation he was particularly interested, because he recognized the high leverage factor, and we talked about that quite a bit.

He said that furthermore—I will repeat again to you—I said, “Why are you interested in paying quite a bit in excess of the break-up value,” and he said that he realized that the only way he could buy a controlling interest in a company of this type is to pay a price somewhat quite a bit above the break-up value at a time when the markets are weak, as they were then. He went on to say that he himself felt that the prices were going to go a good deal higher over a period of time, and he was interested in the leverage factor, again on the upward side \* \* \*.

Notwithstanding the leverage advantages, which Mr. Beal assumed motivated Mr. Beverly in paying a price of \$20 a share for the stock of Continental Securities Corporation with a minus asset value of \$22 a share, Mr. Beverly restricted his purchase to the controlling block of stock held by J. Henry Schroder Banking Corporation. Mr. Beal testified that he requested Mr. Beverly to make the same

<sup>119</sup> Id., at 484-5.

offer to the other common stockholders, but Mr. Beverly was only "interested" in purchasing the sponsor's stock. Mr. Beal did not consider that he owed any duty to the other common stockholders to obtain the same offer for them:<sup>120</sup>

Q. Now did you say to Mr. Beverly: "That is a very nice offer. You are going to pay \$20 a share for stock which has an asset value of minus \$11 [sic., \$22] but will you make the same offer to the other stockholders"?

A. Yes; we did.

Q. What did he say?

A. He said he was only interested in buying the control.

Q. He was only interested in buying enough stock so that he could control the company; isn't that so?

A. That is right.

Q. And you felt it [not] unfair to the other stockholders to get the same price for them as you were getting for yourself?

A. That is correct. We had bought our shares in the open market like anyone else, and I felt we were absolutely satisfied as to the integrity of the new management, that it was not essential for us to get protection for the stockholders. In other words, I want to make it quite clear that originally we had only been sponsoring the company from the viewpoint——

Q. But you did not acquire the management contract in the open market?

A. That is right.

Q. Your other duties did not arise by virtue of your ownership of the common stock? These were independent duties you owed to the stockholders; isn't that so?

A. That is quite right.

Q. Yet you did not insist that the same offer be made to other stockholders, did you?

A. No.

Q. Did you say to Mr. Beverly, "It is true you are buying control, but you are buying control not of my money but of other people's money, and I think they ought to have somebody on the board of directors"; did you say that to him?

A. No.

The contract of sale of the controlling block of stock required J. Henry Schroder Banking Corporation to cancel its management contract with Continental Securities Corporation.<sup>121</sup> Mr. Beal conceded that the effect of the transaction with Mr. Beverly was to turn over to the latter the absolute control and management of approximately \$3,300,000 of liquid assets which belonged to the public:<sup>122</sup>

Q. And you have to be fully conscious of a trust that is almost sacred when you handle other people's money, particularly when it is in the form of liquid securities that can be turned into cash overnight; isn't that so?

A. That is right.

Q. The situation here, then, was that you had this \$3,300,000 of virtually all market securities \* \* \*?

A. Yes; in very large part.

Q. That could be turned into cash overnight; isn't that so?

A. Yes, sir.

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<sup>120</sup> Id., at 494-6.

<sup>121</sup> Id., Commission's Exhibit No. 138.

<sup>122</sup> Id., at 493.

Q. And you were perfectly conscious of the fact that you were turning over to him [Mr. Beverly] \$3,300,000 of other people's money, were you not?

A. Yes.

Mr. Beal testified that Mr. Beverly assured him that the old investment policy of Continental Securities Corporation would be maintained by the new group:<sup>123</sup>

Q. Did you discuss with him [Mr. Beverly] what the nature of the activities was going to be, whether he was going to run it as a diversified trust?

A. I was just coming to that. I said, "Now, one thing you realize, Mr. Beverly, is we have a very strong moral commitment here toward these security holders, and we would not think of selling this trust to anyone unless we felt they were going to continue the policy of running it as a diversified investment trust, and one thing we want to be specifically assured of is that you do not plan to use some of the assets of this company—for instance, to buy securities or pyramid securities of other companies, or buy up interest in other investment companies——"

Q. You mentioned that very definitely.

A. Yes.

Q. What precipitated that? Did you have any information that he was going to do that?

A. No. We talked about, in a general way, about some of the specific securities we had—foreign stocks; he said he might sell some of the foreign stocks but in general there was no doubt in his mind that he was going to run it as we desired him to run it \* \* \*.

However, there was no provision in the contract for the sale of the controlling block requiring the new management to continue the investment policy of Continental Securities Corporation.

Finally, although Mr. Beal conceded that the J. Henry Schroder Banking Corporation stood in a fiduciary relationship to all of the security holders of Continental Securities Corporation, the J. Henry Schroder Banking Corporation did not obtain any representation on the new board of directors of Continental Securities Corporation in order to observe, for the protection of the security holders, the methods of operation of the company by the new group. In fact, although Mr. Beal testified he requested such representation, he finally agreed to turn over the entire board to the Fiscal Management group, since "it was a question of putting through the business on that basis." Mr. Beal testified:<sup>124</sup>

Q. \* \* \* Did you ask whom they were to have on the board so that you could watch what was going on?

A. Yes, we did.

Q. What did he say to that?

A. He said that they would want to have the entire board to themselves.

Q. Didn't that create a little suspicion in your mind? He had five on the board and you wanted one on the board, to see that the rights of the shareholders were protected. Didn't you insist on that?

A. We did not insist, because he said it was a question of putting through the business on that basis, and we gave it a great deal of consideration and

<sup>123</sup> Id., at 485-6.

<sup>124</sup> Id., at 492.

decided that it was all right to go ahead on that basis. If there was but one member on the board there is \* \* \* Mr. Beverly's controlling interest, having one member on the board didn't really matter.

The charter of Continental Securities Corporation required that the directors be elected at the annual meeting of the stockholders or at a special meeting called for that purpose.<sup>125</sup> Of course, the holding of any such meeting would have meant delay and the stockholders would have had to be apprised of the contemplated change in the board of directors.<sup>126</sup> However, Mr. Beal and the Schroder interests proceeded to use a device whereby it was not necessary to wait for the annual meeting or call a special meeting of the stockholders. The scheme used was to have one of the old directors resign, thereby creating a vacancy on the board which could be filled by the remaining members of the board electing a new member to the board; then to have another member of the old board resign and a new member elected until all the members of the old board were replaced seriatim. Mr. Beal testified:<sup>127</sup>

Q. The fact of the matter is that in order to get these people off the Board of Directors, unless they voluntarily resigned, you would have to call a meeting for a new election of the board; isn't that so?

A. I presume that is the case. I don't know.

Mr. DULLES. That is the case, but not in the terms you suggest.

Q. And in that event the stockholders would have to be apprised of the fact that there was a contemplated change in the control of their money; isn't that so?

A. Yes.

Q. But you made it possible for the control to take place without a meeting being held, because you got the voluntary resignations of every director and officer and voluntarily canceled your contract; isn't that so?

A. Yes.

Mr. Dulles, as counsel for Mr. Beal, had suggested and approved this scheme of alternate resignations and elections of directors. He testified:<sup>128</sup>

Q. Were you the one that suggested the mechanics that one director resign and another be elected, that another director resign and a new director be elected, and so on? Who suggested that scheme?

A. That is a very normal procedure at a closing. I suppose I have done that myself in connection with the changes of management companies a dozen times. That is the usual machinery.

Q. That is the usual machinery for that?

A. Correct.

Q. By usual you do not mean justifiable, do you, or sanctionable, do you?

A. Certainly. Yes. If you change managements that is the way, because you have to keep a quorum. The only way to retain your quorum is to have one resign at a time as new directors come in.

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<sup>125</sup> Reply to the Commission's questionnaire for Continental Securities Corporation, Pt. I.

<sup>126</sup> *Op. cit. supra*, note 1, at 498-9.

<sup>127</sup> *Ibid.*

<sup>128</sup> *Id.*, at 1657-61.

Q. I understand that, but as I understand the articles of incorporation of Continental Securities Corporation, the power to elect a new board of directors was vested in the stockholders, wasn't it?

A. Well, they could, but the new directors also could be elected by the board itself.

Q. Yes; but those provisions in the articles of incorporation or the bylaws which say that a board of directors can fill a vacancy, did you conceive that that was intended to mean that you could avail yourselves of that provision and completely turn out the old board and put in a new board?

A. That has been done a great many times.

Q. I understand that. You knew this device of one resigning and another being elected ultimately resulted in the complete wiping out of the old board and the complete new board coming in?

A. That is right.

Q. And you also knew that in a normal situation where you elected a new board of directors it was to have the stockholders do that: wasn't that so?

A. I should say that both situations were quite usual.

Q. By "quite usual" you say both were done. Let me ask you; if it was a question of electing a new board of directors, do you dispute that that was the inalienable right of the stockholders to select their entire new board to manage their funds?

A. They had the right to do it. They did not have the exclusive right.

Q. They could do it if the controlling interests did not indulge in some device which would deprive them of that right to do that; isn't that so? They could do it, as I understand it if the controlling interests would let them do it; but as I understand it, it was intentionally and deliberately done in order not to submit it to the stockholders—when one resigned and another was elected, and then another member resigned and someone was elected in his place, and so on?

A. The majority could, however, have elected the new board in a few weeks under the regular procedure under the Maryland law.

Q. Or it could be done at the regular annual meeting?

A. With notice; yes.

Q. But if a special meeting was called, it was necessary to put in the notice that the purpose was to clean out the old board and put in a new board?

A. That is so.

Q. And although that might have been managed from the point of view of voting power, because the controlling block was in the hands of the people who were selling the interest, you could not anticipate what legal steps the stockholders would take under the circumstances to possibly protect their interests; isn't that so?

A. Correct.

Q. So that this device of, shall we say "ring-around-the-rosy"—one going off and another going on, one going off and another going on, another going off and another going on, had as an ultimate end, did it not, to substitute a complete new board of directors?

A. That was the case.

Q. It was not a case where one fellow became sick and could not fulfill his duties as a director, an exigency, existed, a vacancy was created, and where somebody had to be substituted, was it?

A. No.

Q. They were all in perfectly good health?

A. Perfectly good health.

Q. And all compos mentis, too?

A. All compos mentis.

Mr. Beal furthermore did not apparently make any investigation of the individuals who were to be the new directors of the investment company representing the Fiscal Management group. When examined with respect to this he testified:<sup>129</sup>

Q. In the course of this conversation with Mr. Beverly, did you ask him whom he was going to put on the board of directors?

A. Mr. Beverly mentioned two names, and I think we have mentioned——

Q. Ex-Congressman Frear?<sup>130</sup>

\* \* \* \* \*

A. Yes.

Q. And Mr. Ross?

A. Mr. Ross.

Q. Did Mr. Ross' name mean anything to you?

A. No, sir.

Q. Not then?

A. No.

Q. You had never heard that name before; isn't that so?

A. Yes; that is right.

Q. How many members are there on the board of directors?

A. I think there are six altogether.

Q. Six altogether?

A. Yes.

Q. So you got three; did he give the names of the other three?

A. He did before we went through with the deal; yes.

J. Henry Schroder Banking Corporation had previously sold control of American, British & Continental Corporation without prior notice to the other security holders.<sup>131</sup> Although Mr. Beal had been examined in October 1936 in connection with the Commission's study of the transfer of control of American, British & Continental Corporation and was thereby aware of the problems involved in transferring control of an investment company, he did not attempt to obtain any information from the Commission's investment trust staff as to the prospective purchasers of Continental Securities Corporation. Mr. Beal testified:<sup>132</sup>

Q. You had sold an investment trust once before, hadn't you, Mr. Beal, American, British and Continental?

A. That is quite right.

Q. And you were examined down in Washington in connection with that transaction?

A. Yes.

Q. In the course of our investment trust study?

A. Yes.

<sup>129</sup> Id., at 489.

<sup>130</sup> Mr. Beal testified as follows with respect to the extent to which he investigated James Frear (recently deceased) (id., at 487, 489):

Q. Did you ask him who Mr. James Frear was?

A. Yes.

Q. What did he tell you?

A. That he was an ex-congressman from Wisconsin.

Q. And that was sufficient to satisfy you as to his capability or right to get \$3,500,000 of other people's money?

A. No, sir.

Q. Did you stop to find out who Mr. James Frear was?

A. No; because we were interested in Mr. Beverly.

<sup>131</sup> Public Examination, American, British & Continental Corporation, at 4841-8.

<sup>132</sup> Op. cit. supra, note 1, at 499-500.

Q. And you were examined at some length about the propriety and ethics of selling control of an investment trust without apprising the stockholders of the fact that it was being done; do you remember that?

A. I remember that.

Q. That was in 1936, the summer of 1936, July, and two years later you sold this trust without apprising the stockholders before you sold it, isn't that so?

A. Yes.

Q. Did you go to the S. E. C.—you knew we were making a study for over two years—did you come to us and ask “Do you know anything about Mr. Beverly, or what his associations are with investment trusts, or Mr. Frear?” Did you discuss the situation with the Commission before you passed control?

A. No, we did not.

The contract providing for the transfer of control of Continental Securities Corporation to the Fiscal Management Company, Ltd., fixed October 25, 1937 as the closing date. Two days prior thereto, Paine, Webber & Co. had been requested by Mr. Solomont to make an advance of \$580,000 to be secured by \$2,500,000 of securities which were contained in a list shown to Stephen Paine, a partner in that brokerage firm.<sup>133</sup> Mr. Paine testified that he “did not pay much attention” to the list, although its size and diversification should have given him some indication that the list of securities belonged to “some institution, either an insurance company, or an investment trust.”<sup>134</sup> These securities were described to him by Mr. Solomont as belonging to a client of Thomas W. Morris, who was a Boston attorney and friend of Mr. Solomont.<sup>135</sup> Mr. Paine, without any further questions, agreed to make the advance and had a firm check for \$580,000 made payable to the order of Mr. Solomont because “he [Solomont] did not know to whom it ultimately was going.”<sup>136</sup> In accordance with Mr. Solomont's request, a representative of Paine, Webber & Co. was sent to Jersey City on October 25, 1937 to pick up the securities which were to be turned over to that firm as collateral.<sup>137</sup>

The Paine, Webber & Co. check for \$580,000, payable to S. Leo Solomont, was turned over to Mr. Solomont by one Vernon Smith, a representative of Paine, Webber & Co. on October 25, 1937, while Mr. Smith was checking the securities but prior to the receipt by him of these securities. Mr. Smith testified:<sup>138</sup>

Q. Now, you got over to Jersey where the closing was taking place. Where were you during the time that all the activity was going on in Jersey?

A. I wasn't aware of any activity going on except in the room where I was with the securities.

Q. You were counting the securities?

A. Yes, sir.

\* \* \* \* \*

Q. What happened, what did anybody say to you?

A. Solomont was there and he asked me for the check and I gave it to him and my recollection is he left the room.

<sup>133</sup> Id., at 279–84 and Commission's Exhibit No. 29.

<sup>134</sup> Id., at 281.

<sup>135</sup> Id., at 283.

<sup>136</sup> Id., at 290–1.

<sup>137</sup> Id., at 285–6.

<sup>138</sup> Id., at 1713–5.

Q. Did Mr. Beal or anybody from Continental Securities Corporation tell you you could take these securities?

A. I don't know Mr. Beal. I didn't know him. I know now.

Q. Who told you it is all right for you to take the securities?

A. That was when Solomont came back.

Q. He said it is all right for you to take the securities, give me the check, is that it?

A. No, I gave him the check first.

Q. Yes.

A. And he left the room and I continued checking the list I had with the receipt which I signed, and when he came back he said, "It is all right, we are ready to go," or words to that effect.

Mr. Solomont endorsed the check over to J. Henry Schroder Banking Corporation and immediately took possession of the portfolio securities of Continental Securities Corporation, which were being "checked" by Vernon Smith. When examined with respect to this transfer, Mr. Beal testified:<sup>139</sup>

Q. Just tell us what happened.

A. We still had control of the company. At that point the exchange of the check and securities took place, so that we did not give up the control of the company or of the securities until after we had received the check and were satisfied.

\* \* \* \* \*

Q. Did you go over to the vault and take out the securities?

A. No, the people in our office did.

Q. Did they bring the securities with them?

A. No, I think the new owners of Continental went to the vault later on and they acquired possession of the securities only after the necessary resolutions, I believe, had been passed.

Q. Are you sure that nobody from Schroder or your representatives took the securities out of the vault?

A. Well, our men were in the vault with the securities, and they turned over the securities to the new owners.

Q. Who told them to turn them over?

A. Well, the control had passed from our hands and somebody, I suppose one of our men, authorized these people at that point to go into the vault.

Q. Did you see a representative of Paine, Webber & Co. there?

A. I did not personally myself, but others did.

Q. You say it was a Paine, Webber check that you got?

A. Yes.

These portfolio securities, which constituted practically the entire assets of Continental Securities Corporation, were thus removed by the Fiscal Management group immediately upon the transfer of control. These securities were thereupon turned over to Paine, Webber & Co. Mr. Beal testified:<sup>140</sup>

Q. How many securities did you have in that box?

A. Down in the vault?

Q. Yes.

A. Well, quite a few securities; I don't know.

<sup>139</sup> Id., at 503-5.

<sup>140</sup> Id., at 505-6.



Q. Wasn't it approximately \$2,500,000 worth of securities?

A. I would have to verify that figure, but I suppose a substantial proportion of the securities were there.

Q. So that the whole investment trust, virtually, was in that vault box; isn't that right?

A. That is right.

Q. And it was put into a package, and as far as you know some individual walked off with the whole trust; isn't that so?

A. Well, the new management did.

Q. The new management?

A. He got the securities at that point. I don't know much about the mechanics of it, because I was not there, and other people from our organization knew exactly what happened.

Q. But practically the whole investment trust was in a safe deposit box and was taken out of the box and moved away, as far as you know; isn't that so?

A. Yes; as I say, I did not see that myself, but that is my understanding of what happened.

Q. Just candidly, Mr. Beal, didn't you feel a little uneasy at that moment when you told these people to go down and take the whole investment trust and take it away and manage it as they pleased?

A. Not a bit.

Mr. Smith described the method by which practically the whole investment trust was moved in a "canvas bag," as follows:<sup>141</sup>

Q. In any event, when you got there the securities were on the table and you counted them?

A. Yes.

Q. And what did you do with them afterward?

A. Called the messengers up and put them in a bag and brought them into the office.

Q. Just put two or two and a half million dollars worth of securities in—what was it, a valise?

A. No; a large bag.

Q. And then went off with it?

A. Yes.

Q. You didn't know you had an investment trust in your valise, did you?

A. No; I didn't.

Q. Perfectly oblivious to the fact you were taking an investment trust through the Hudson Tube, or was it by the ferry?

A. Through the tube.

Q. Did the investment trust get into one valise? I am curious how you move an investment trust from one city to another.

A. They have a bag about that high and that wide.

Q. A regular—

A. Two men carry it, a regular canvas, leather bag.

The transfer of these portfolio securities to Paine, Webber & Co. had been authorized by a series of resolutions adopted by an entirely new board of directors and entirely new officers, all of whom were designated by the Fiscal Management group to replace all the members of the old board and officers who resigned in accordance with the terms of the contract.<sup>142</sup> These new officers, who had been elected on

<sup>141</sup> Id., at 1716-7.

<sup>142</sup> Id., Commission's Exhibit No. 138.

October 25, 1937 to represent the Fiscal Management group, included George F. Bahntge as president, Charles B. McAllister as secretary, and Herbert B. Bolton as treasurer. The directors included James Frear, the father of Philip A. Frear, and described as a former Congressman from Wisconsin,<sup>143</sup> Harry H. Curtis, son of Charles J. Curtis, former Vice President of the United States,<sup>144</sup> and Fred Ross.<sup>145</sup>

George F. Bahntge, who, on October 28, 1937, resigned as president and became treasurer of Continental Securities Corporation<sup>146</sup> had been a "customer's man" with Prentice & Brady<sup>147</sup> and had had no experience with investment companies. He had been asked to become an officer of Continental Securities Corporation by Mr. Clayton.<sup>148</sup> Mr. Bahntge had also been made an officer of First Income Trading Corporation when control of that investment company had been acquired by the Fiscal Management group. Mr. Bahntge testified:<sup>149</sup>

Q. When did Mr. Clayton ask you to become treasurer of Continental?

A. I guess August or September of 1937. I wasn't doing so well as a customer's man and the market was down and business was bad and he knew I was a little dissatisfied because, as I say, conditions were bad and I wanted to get something else.

He told me when he had a talk with me one day, he said, "Why don't you stick around? We are negotiating for some investment trust and we may have a position for you and we will take care of you."

While he was treasurer of Continental Securities Corporation, Mr. Bahntge performed no substantial duties, nor was he requested to do so. Mr. Bahntge testified:<sup>150</sup>

Q. Did you have any particular space as treasurer of Continental?

A. No; not at all.

Q. You continued to make your office with Prentice & Brady?

A. Just for a while, and then I went up to Ferretti's office for approximately a month and would go early in the day for an hour or two and finally he suggested it might be well for me to stay right downtown in the office of First Income [Trading] Corporation.

Q. Was that before or after you became vice president of First Income?

A. That was while I was treasurer of Continental, and then I don't recall the day I was made vice president of the First Income, but I think that was sometime in December 1937.

\* \* \* \* \*

Q. And you were already making your office at the First Income's office down on lower Broadway?

A. Yes. I just sat around.

\* \* \* \* \*

Q. Now, what work did you do as Treasurer of Continental?

A. Nothing at all, except sign checks.

<sup>143</sup> See *supra*, p. 376.

<sup>144</sup> *Op. cit. supra*, note 1, at 1315.

<sup>145</sup> *Id.*, Commission's Exhibit No. 138.

<sup>146</sup> Fred Ross then became president of Continental Securities Corporation. (*Ibid.*)

<sup>147</sup> *Id.*, at 1490.

<sup>148</sup> *Ibid.*

<sup>149</sup> *Id.*, at 1491.

<sup>150</sup> *Id.*, at 1492-3.

Q. And receive checks?

A. Yes; sign checks and sign letters, confirmations of buying and selling orders to the brokers, Prentice & Brady.

The new board of directors of Continental Securities Corporation on October 25, 1937, immediately after the closing of the contract, authorized the assignment of the greater portion of the portfolio securities of Continental Securities Corporation, which had a market value of \$2,500,000, to John S. McKay, secretary of First Income Trading Corporation.<sup>151</sup> Mr. McKay, a bleach salesman, making a salary of approximately \$30 a week,<sup>152</sup> had been made secretary of First Income Trading Corporation and had been placed on the board of directors of that company by Mr. Clayton, one of the Fiscal Management group.<sup>153</sup> Mr. McKay testified that he had known Mr. Clayton for many years.<sup>154</sup> In July 1937, just prior to the acquisition of control of First Income Trading Corporation by the Fiscal Management group, Mr. McKay "ran into him [Clayton]" accidentally. Mr. McKay testified:<sup>155</sup>

Q. Tell me when you first started seeing a great deal of him [Clayton] recently.

A. In July; the latter part of July.

Q. Of 1937?

A. 1937.

Q. Where was that?

A. Down in the street somewhere around Broadway, lower Broadway and Broad Street.

Q. Now, getting down to the transactions involved in connection with Continental Securities Corporation, when is the first time he ever spoke to you about that?

A. About in July 1937.

Q. And where did you meet him?

A. On lower Broadway, New York.

Q. On the street?

A. On the street.

Q. You do not have any office, do you?

A. No.

Q. Did Mr. Clayton have an office?

A. Pardon me, I would like to correct that. I do have an office in the Bronx, where my headquarters—

Q. You mean in the laundry business?

A. Yes; in the laundry business.

Q. Not for the securities business?

A. No; not for the securities business.

Q. Did Mr. Clayton have an office uptown, too?

A. Not that I know of.

Q. You just ran across him in the street?

A. I ran across him in the street.

Q. You ran across him quite frequently by accident; isn't that right?

A. By accident; yes.

<sup>151</sup> Id., Commission's Exhibits Nos. 32, 34, and 138.

<sup>152</sup> Id., at 394-395.

<sup>153</sup> Id., at 404.

<sup>154</sup> Id., at 396-7.

<sup>155</sup> Id., at 397-8.

Q. And how many times did you run across him by accident a couple of weeks before this deal was mentioned to you?

A. Oh, maybe once or twice a week.

Q. Is your laundry or bleach district up in the Bronx or downtown in Wall Street, then?

A. All over the Metropolitan district.

Q. Do you sell bleach down in Wall Street?

A. No, sir.

\* \* \* \* \*

Q. You said you ran into him accidentally down in the street—and what did he say to you?

A. He said I better keep in touch with him; he thought he had a job for me to put me to work.

Thereupon Mr. Clayton gave Mr. McKay a job with the Trans-Atlantic Fund at \$25 a week, and Mr. McKay was allowed to carry on his laundry business on the side. When examined with respect to his position with this company, he testified:<sup>156</sup>

Q. \* \* \* you worked for a company known as the Trans-Atlantic Fund, isn't that so?

A. That is right.

Q. What kind of a corporation is that?

A. It was a corporation that did not do any work at all. They were going to make commitments on the stock market.

Q. Did they tell you what this business was?

A. No.

Q. Where was their office?

A. 25 Broadway.

Q. Do you remember the floor?

A. On the fifth floor; yes, sir.

Q. How many rooms did they have?

A. One large room.

Q. Who was the head of Trans-Atlantic?

A. I understand the original head of it was a man by the name of Braithwaite.

Q. And then who took it over?

A. Mr. Ferretti took over Mr. Braithwaite's place.

Q. And what was Clayton's connection with the Trans-Atlantic Company?

A. Nothing to my knowledge.

Q. But Clayton hired you, is that it?

A. Yes, sir.

Q. And what was your salary?

A. \$25 a week.

Q. Could you still carry on your laundry business?

A. Yes, sir.

Q. That was just a side job?

A. That is right.

Q. How much time did you spend there?

A. Very little on the laundry business, and on Saturdays and Sundays.

Q. Very little on laundry?

A. Very little on laundry.

Q. Very little on the Trans-Atlantic [Fund]?

A. Very little on both of them.

<sup>156</sup> Id., at 399-401.

Q. When they wanted you, they would call you, is that it?

A. No; I would always be in there.

Q. And that was \$25 a week you were getting?

A. Yes, sir.

Q. Were you an officer of that corporation?

A. No—yes, I beg your pardon; I think I was an officer.

Q. But you don't know——

A. I think I was vice president of the Trans-Atlantic [Fund].

Thereafter, upon the acquisition of First Income Trading Corporation by the Fiscal Management group, Mr. McKay was given a job with that company. He testified:<sup>157</sup>

Q. Now they told you they had a job for you as a clerk with First Income Trading Corporation, is that it?

A. Yes.

Q. Didn't they make you an officer of First Income Trading Corporation?

A. Yes, sir; they did.

Q. What officer were you?

A. Vice president and director.

Q. They told you they made you vice president, is that it or when did they tell you that, before they elected you or after?

A. After they elected me.

Q. They said "You have been promoted from clerk to vice president of the First Income Trading Corporation"?

A. Yes, sir.

Q. And did you get any salary as vice president of the First Income Trading [Corporation]?

A. I just got the \$25 a week.

Mr. McKay, when examined as to his duties and work, testified:<sup>158</sup>

Q. Did you ever give them advice as to what investments to make?

A. No, sir.

Q. Did you ever talk about the business of First Income?

A. No, sir.

In October 1937 Mr. McKay was requested to resign as vice president of First Income Trading Corporation and was designated secretary of this investment company. When examined with respect to this change in position, Mr. McKay testified:<sup>159</sup>

Q. \* \* \* Now, you were made vice president of First Income Trading Corporation, and you say you were vice president how long?

A. For about, I imagine, two months.

Q. And then what did they say to you?

A. Then they accepted my resignation as vice president and made me secretary and director, and then, I don't know, director or vice president, and I was then secretary of First Income.

Q. You were demoted, is that it?

A. Demoted.

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<sup>157</sup> Id., at 401-2.

<sup>158</sup> Id., at 403.

<sup>159</sup> Id., at 404.

Q. What did they do? Put the papers in front of you and tell you to sign them, is that it?

A. Yes, sir.

Q. Then you resigned as vice president and now you were secretary, is that it?

A. Yes; practically.

Mr. McKay was the individual to whom, on October 25, 1937, the entire portfolio of Continental Securities Corporation consisting of marketable securities of the value of \$2,500,000 was assigned.<sup>160</sup> These securities were the same securities contained in the list shown to Paine, Webber & Co. and on which that firm advanced \$580,000<sup>161</sup> ostensibly to a client of Mr. Robb, the Boston attorney. On the same day, October 25, 1937, Mr. McKay executed an assignment of the \$2,500,000 worth of portfolio securities to Messrs. Solomont and Robb.<sup>162</sup> All these securities had been taken away by Vernon Smith, representative of Paine, Webber & Co. at the closing, as collateral for the advance of \$580,000 which had been used to purchase the control block of stock of Continental Securities Corporation from the Schroeder interests. Mr. McKay was authorized to liquidate \$700,000 worth of these portfolio securities and to use the proceeds to purchase 7,000 shares of preferred stock of Fiscal Management Company, Ltd., at \$100 per share. As part of the same transaction, Mr. McKay then sold all these preferred shares to Continental Securities Corporation at \$100 a share for a total of \$700,000.<sup>163</sup> The balance of the \$2,500,000 of portfolio securities was to be returned to Continental Securities Corporation.<sup>164</sup>

Mr. McKay denied that he had any knowledge that these portfolio securities had been assigned to him, or that he had reassigned them to Messrs. Solomont and Robb. When examined on this transaction he testified:<sup>165</sup>

Q. George Clayton brought that paper to you and said, "I want you to sign it"?

A. Yes; but I did not read it.

Q. Who spoke to you about that first?

A. Clayton.

Q. What did he say?

A. He said, "I want you to act as an agent, being you are a resident of Jersey; we will save some taxes if you act as agent." They were transferring some securities from a Canada company into the Continental Securities Corporation.

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<sup>160</sup> See *supra*, p. 390.

<sup>161</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. 29.

<sup>162</sup> *Id.*, Commission's Exhibit No. 33.

<sup>163</sup> *Id.*, Commission's Exhibit No. 138. The minutes of Fiscal Management Company, Ltd., indicate that on October 15, 1937, an offer was made by Fiscal Management Company, Ltd., to sell to Continental Securities Corporation 7,000 shares of preferred stock of Fiscal Management Company, Ltd., for \$700,000; and that \$580,000 of these proceeds was to be turned over to J. Henry Schroder Banking Corporation for their control block of stock in Continental Securities Corporation. (*Id.*, Commission's Exhibits Nos. 64 and 138.)

<sup>164</sup> *Id.*, Commission's Exhibit No. 138.

<sup>165</sup> *Id.*, at 406-9.

Q. What Canada company?

A. I don't believe he mentioned it at the time.

\* \* \* \* \*

Q. You did not ask the name of the Canadian corporation, did you?

A. No, sir.

Q. Did you read this paper when you signed it [assignment by Mr. McKay of the securities of Continental Securities Corporation to Messrs. Solomont and Robb]?

A. No, sir.

Q. What did they do, just put it in front of you and ask you to sign?

A. In the course of the papers I signed, there were three or four papers they asked me to sign and I would sign it.

\* \* \* \* \*

Q. Didn't they tell you, Mr. McKay, that they were going to execute an assignment to you of approximately two and one-half million dollars of securities of Continental Securities Corporation?

A. No, sir.

Q. Did they tell you they were going to execute an assignment to you of this two and one-half million dollars of securities, and that you were to have the discretion to sell those securities until you realized \$700,000?

A. No, sir.

Q. You know they first turned over to you that assignment of two and one-half million dollars of Continental Securities Corporation, don't you?

A. I understand now these were the mechanics of it, but as to what was going to happen, I did not know how it was going to take place.

Q. So that when you signed this paper, you did not know what the deal was about, did you?

A. No, sir.<sup>166</sup>

These portfolio securities which were thus assigned to Messrs. Solomont and Robb were turned over to Paine, Webber & Co. as collateral for its advance of \$580,000 to S. Leo Solomont.<sup>167</sup> These securities were segregated by Paine, Webber & Co., in accordance with the direction of Mr. Solomont, into two accounts: a joint account in the name of Solomont and Robb to contain \$700,000 of these securities and an account designated "Continental Securities Corporation, Account No. 75" to contain the balance.<sup>168</sup>

Paine, Webber & Co. was directed to liquidate the \$700,000 of the portfolio securities put in the "Solomont and Robb account" and to deduct the firm's advance of \$580,000 to Mr. Solomont from the pro-

<sup>166</sup> Apparently, as a reward to Mr. McKay for cooperating with the Fiscal Management group on this transaction, Mr. McKay's salary was raised to \$50 a week. Mr. McKay testified (*id.*, at 410):

Q. After you signed this paper did they increase your salary?

A. Two weeks after that they did.

Q. They gave you how much?

A. \$50 a week.

Q. Did they tell you why they raised your salary?

A. No, sir; they did not tell me. It was Mitchell who told me that my salary would be \$50 a week.

Q. What did he say to you?

A. He said, "You ought to get more money here because you are here all day long and attending to business, you ought to get more money; your salary will be \$50."

<sup>167</sup> See *supra*, pp. 386-7.

<sup>168</sup> *Op. cit. supra*, note 1, at 296-9 and Commission's Exhibits Nos. 35, 42, and 43.

ceeds.<sup>169</sup> Stephen Paine took no steps to confirm this direction with J. Henry Schroder Banking Corporation, although he knew that the securities belonged either to that investment banking house or to some organization with which the house was connected since the securities were in the name of Tucker & Co., the usual nominee of that investment banking house.<sup>170</sup> Mr. Paine further testified that, with respect to the authorization and papers which had been turned over to him by Mr. Solomont on October 28, 1937, he "simply looked at them casually."<sup>171</sup> Mr. Paine admitted these documents on their face disclosed, among many things, that portfolio securities of the Continental Securities Corporation were liquidated on the direction of the Fiscal Management group, and the proceeds were to be used by the Fiscal Management group to purchase the controlling block of stock of Continental Securities Corporation from J. Henry Schroder Banking Corporation.<sup>172</sup> The advance which had been made by Paine, Webber & Co. merely constituted the medium whereby the Fiscal Management group could acquire control of the securities of Continental Securities Corporation, for the assets of that investment company were immediately used to reimburse Paine, Webber & Co.

Approximately \$850,000 was realized on the sale of the portfolio securities placed in the Solomont and Robb account.<sup>173</sup> The brokerage firm deducted \$580,000 to satisfy their advance to Mr. Solomont.<sup>174</sup> The balance of the proceeds was distributed in part as "commissions" to the individuals in the Fiscal Management group, and in part credited to the Continental Securities Account No. 75. One check for \$25,000 was made payable to the order of Solomont and Robb and ostensibly constituted their "commission" for effecting the loan from Paine, Webber & Co.<sup>175</sup> Mr. Paine denied any knowledge of the fact that Mr. Solomont and/or Mr. Robb was to receive \$25,000 as "commissions."<sup>176</sup> A second check for \$91,246.35 to Messrs. Solomont and Robb was distributed to the individuals in the Fiscal Management group as

<sup>169</sup> Id., at 283.

<sup>170</sup> Id., at 300.

<sup>171</sup> Id., at 309.

<sup>172</sup> Id., Commission's Exhibit No. 149. A letter of October 25, 1937, from John S. McKay to Messrs. Solomont and Robb stated, "with reference to the \$580,000 which you are to advance under the terms of my letter of even date to you, I hereby direct and nominate that you pay said \$580,000 to J. Henry Schroder Banking Corporation." The letter to which Mr. McKay referred was also dated October 25, 1937 (id., Commission's Exhibit No. 148) and stated, "with reference to the securities that I transferred, assigned, and delivered to you (id., Commission's Exhibit No. 33) you are authorized \* \* \* to sell any or all of said securities \* \* \* and to retain \$605,000 from the proceeds thereof in consideration of your advancing \$580,000 to me or my nominee on this day \* \* \*". (Id., at 309.)

<sup>173</sup> Mr. Paine testified that "he sold about \$700,000 for their account". (Id., at 313.) However, if account be taken of the two checks for \$122,050 and \$34,984.33 which were transferred to the account of Continental Securities Corporation, Account No. 75, Paine, Webber & Co. must have liquidated securities whose value was approximately \$850,000.

<sup>174</sup> See *supra*, pp. 386-7.

<sup>175</sup> See *supra*.

<sup>176</sup> Op. cit. *supra*, note 1, Commission's Exhibit No. 36.

<sup>177</sup> Id., Commission's Exhibit No. 148. However, among the papers in the possession of Paine, Webber & Co. relating to this transaction was a letter from Mr. McKay to Messrs. Robb and Solomont which disclosed the fact that Messrs. Solomont and Robb were to receive this \$25,000. For more detailed discussion of this document see *infra*, pp. 481-2.



their "profit" on the transaction<sup>177</sup> in which they "didn't put up a nickel."<sup>178</sup> Two additional checks, one for \$122,050 and another for \$34,984.33 were made payable to the order of Continental Securities Corporation and were credited to the Continental Securities Corporation Account No. 75.<sup>179</sup> The joint account of Solomont and Robb was thereafter closed.<sup>180</sup> Subsequently, Account No. 75 was also closed and the securities in this account were transferred to Prentice & Brady, for the account of Continental Securities Corporation.<sup>181</sup>

To recapitulate the mechanics and the consequence of these transactions in connection with the Continental Securities Corporation: Paine, Webber & Co. advanced \$580,000 against \$2,500,000 of portfolio securities of Continental Securities Corporation; the \$580,000 advance was used to purchase from the Schroder interests the controlling block of common stock of Continental Securities Corporation. Immediately upon obtaining control, the Fiscal Management group turned over to Paine, Webber & Co. the \$2,500,000 of portfolio securities, and Paine, Webber & Co., pursuant to the direction of the group, sold a portion of the portfolio securities of Continental Securities Corporation in the open market, realizing \$850,000. From this \$850,000 Paine, Webber & Co. deducted its advance of \$580,000 and turned over to Leo Solomont and Ralph Robb \$25,000, ostensibly their "commissions" in the transaction, and an additional \$91,246.35 to Messrs. Solomont and Robb, who distributed this sum to the individuals of the Fiscal Management group as their "profit" on the transaction. The balance of \$157,034.33 was turned in to an account opened in the name of Continental Securities Corporation at Paine, Webber & Co. To "reimburse" Continental Securities Corporation for the portfolio securities which had been sold, Continental Securities Corporation was compelled to accept 7,000 shares of the preferred stock of Fiscal Management Company, Ltd., at \$100 per share for an aggregate of \$700,000. Fiscal Management Company, Ltd., in consideration of the issuance of its 7,000 shares of preferred, received the controlling block of common stock of Continental Securities Corporation which the group had acquired for \$580,000 from the Schroder interests. Continental Securities Corporation was then left in a position similar to First Income Trading Corporation: Fiscal Management Company, Ltd., held the controlling block of stock of Continental Securities Corporation which it acquired by the use of the funds of Continental Securities Corporation, and Continental Securities Corporation in turn held 7,000 shares of the

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<sup>177</sup> Id., at 302, Commission's Exhibit No. 37.

<sup>178</sup> Id., at 610.

<sup>179</sup> Id., at 305 and Commission's Exhibit Nos. 38 and 39.

<sup>180</sup> Id., at 313.

<sup>181</sup> Ibid.

preferred stock of the Fiscal Management Co., Ltd., in lieu of its marketable portfolio securities which had been sold.<sup>182</sup>

<sup>182</sup> This transaction, whereby \$700,000 worth of marketable portfolio securities were replaced with the preferred stock of the Fiscal Management Company, Ltd., the personal holding company of the Fiscal Management group, had been submitted for legal opinion to Mr. Sims, an attorney and partner in the firm of Sage, Gray, Todd & Sims. About September 30, 1937, while Lansing MacVickar was negotiating with Mr. Beal for the sale of the common stock of Continental Securities Corporation at \$20 a share, Alexander Beverly had requested the New York branch office of the Royal Bank of Canada to make a loan to facilitate the acquisition of this block of stock. Mr. Sims, the New York counsel for this bank, testified as follows (id., at 625-9) :

Q. You said a loan would be required. Will you give us the details with respect to what was said on this line?

A. I cannot give it to you in any detail because, they being technical banking transactions, I did not pay very much attention to them; but my recollection was that the bank would be asked to make a loan to Fiscal Management Corporation upon its note, guaranteed by Mr. Beverly, and that the proceeds of that loan would be used to acquire the stock of the Continental Securities Corporation which was owned by Schroder; that thereafter, immediately thereafter, a certain amount of the preferred stock of Fiscal Management Corporation would be sold to the Continental Securities Corporation, and with that money the Fiscal Management Corporation would pay the loan to the Royal Bank of Canada. That is [it] in substance.

Q. Was it then disclosed to you by Mr. Beverly or Mr. Binch [attorney for Mr. Beverly] as to what the technique would be; that they would make a loan at the bank, and as you understood it, the loan from the bank would be guaranteed by Mr. Beverly; they would then buy the controlling block of stock; and in order to pay off the loan, after they got control of the Continental Securities Corporation, they would sell the securities of the Continental in an amount sufficient to pay that loan; isn't that so?

A. Yes.

Q. And then reimburse the Continental for the securities which were sold out of its portfolio by selling it the Fiscal Management preferred stock?

A. Substantially that.

Q. That was fully disclosed to you at that time?

A. I think it was.

Q. So that you knew at the time that your opinion was asked, and subsequently rendered your opinion, that the money of the investment trust was going to be used by Mr. Beverly and the Fiscal Management Company, Ltd., to acquire Continental Securities Corporation; isn't that so?

A. With the proceeds of the sale of the First Income stock to Fiscal and Fiscal to Continental, would be used for that purpose.

Q. Wasn't that it, then; that the loan would first be made, the controlling block bought, and then Continental Securities Corporation stock sold to pay off the loan; isn't that so?

A. Yes.

Q. Then the situation would be, would it not, Mr. Sims, that Fiscal Management Company, Ltd., was selling its preferred stock to Continental Securities Corporation at \$100 a share—

A. Yes; at par.

Q. And they were going to sell it \$700,000 worth; do you recall?

A. Somewhere about that figure.

Q. So that when Fiscal Management Company, Ltd., was selling \$700,000 of its preferred stock to Continental Securities Corporation, it would be at a time when Fiscal Management Company, Ltd., had control of the Continental Securities Corporation?

A. Yes; there is no question about that.

Q. And the prices to be paid by Continental Securities Corporation for the Fiscal Management Company, Ltd., stock, of course, would be fixed by Mr. Beverly; isn't that so, having control of the Continental Securities Corporation? He was the one to determine whether Continental Securities Corporation was prepared to pay \$100 for that preferred stock?

A. Well, I don't know whether Mr. Beverly had control of Continental or control of Fiscal, or either of them; I only knew him as a party in it.

Q. But you knew \* \* \* that the transaction was going to be worked out by the same people who you knew controlled Fiscal Management Company, Ltd., and you knew they were the same people who controlled Continental Securities Corporation, and therefore they were sitting on both sides of the table, dealing with themselves, when they had Fiscal sell \$700,000 of securities to Continental Securities Corporation. There is no question about that?

A. Oh, no; that was perfectly well understood.

Q. That was well understood?

A. Yes.

Q. Of course, there was an apparent conflict of interest there, was there not?

A. Very apparent.

Mr. Sims, however, despite his recognition of the fact that there was an "apparent conflict of interest" in this transaction, found no "legal or ethical difficulties" with the transaction, and minimized the possible claims which the minority stockholders of Con-

As soon as the Fiscal Management Company, Ltd. assumed control of Continental Securities Corporation the group commenced to deplete and dissipate the balance of the portfolio securities and assets of that investment company.

Continental Securities Corporation might have against Mr. Beverly for effecting this transaction. When examined with respect to this, Mr. Sims testified (id., at 630-6) :

Q. And you also knew that at the time they proposed the proposition to you that Beverly had no interest in Continental Securities Corporation, but that the money belonged to the stockholders in Continental; isn't that so?

A. Yes.

Q. They also apprised you of the fact, did they not, that they were paying \$20 a share for stock which you say had a market value of ten to twelve, and we will introduce the price in the market if you want us to prove that.

A. No.

Q. You will take our word for that?

A. Oh, yes.

Q. Did you ask him what the asset value of Continental Securities Corporation common stock was?

A. I did not ask him, but they already had some statements, and I read a great many figures which meant very little to me.

Q. They told you, did they not, that the dividends had been passed on the preferred of the Continental Securities Corporation, and that \$27 had actually accrued?

A. No.

Q. Did they tell you that at the time that that common stock had an asset value of minus eleven dollars [sic., \$22]?

A. No.

Q. Would that have changed or helped you, had you known that, or would you have given the same advice, regardless of what the asset value was?

A. I think I should have given the same opinion that I did.

Q. With the consciousness that that conflict existed, I am just trying to visualize the duties you felt you had in that situation. Did you feel that you had any duty to the Continental Securities Corporation stockholders?

A. No.

Q. \* \* \* Was it your opinion that you were being retained to work this deal out so that it would comply with the legal requirements and that it could not be legally upset?

A. Oh, no; never.

Q. Did you assume that they merely wanted to get your advice on the legal aspects of it, or did you feel also that there was a little concern about the ethics in that situation?

A. I thought it was merely a question of legal advice to the bank at the outset.

Q. You were not advising Beverly whether he could do this?

A. I did not think of that during the conference, but at the end of the conference, when I was asked for an opinion, a written opinion on the subject, there was some talk about it, and I was asked if I would send the original opinion addressed to Mr. Birch.

Q. Who you knew was Mr. Beverly's attorney?

A. Who I knew was Mr. Beverly's attorney, and to send a copy of it to the bank. That was the first intimation I had that Mr. Beverly might in any way rely on the opinion.

Q. Did you say to Mr. Beverly, "Regardless of the legal aspects of this transaction, I have some ethical difficulties with it, Mr. Beverly, or Mr. Birch, knowing that not only are you the people on both sides of the table in this transaction, but it seems to me that you are going to use the funds of the Continental Securities Corporation to acquire control of the Continental Securities Corporation"?

A. No; I did not pass any judgment on the question of ethics.

Q. You felt, as a lawyer, that that was no concern of yours; is that it?

A. No concern of mine.

Q. \* \* \* you read the law to see how far people can go in dealing with themselves without having the transaction upset, isn't that so?

A. That is substantially correct, yes. I might say there that I was asked, \* \* \* the question that I was specifically asked, and with which the opinion is principally concerned, is what rights the minority stockholders would have to upset the transaction under the law. That is substantially what I was asked.

In his opinion, Mr. Sims substantially stated that there definitely was no principle of law which "forbids or renders invalid or voidable transactions between the controlled corporation and the person in control or corporation in turn controlled by him. If any particular transaction is a prudent, honest, and proper transaction for the corporation to make, it will be sustained; otherwise, it may be set aside upon the suit of minority stockholders \* \* \*. In reaching a conclusion on this question all of the surrounding circumstances have to be taken into consideration and a purchase of the preferred stock of Fiscal Management Company, Ltd., by another controlled corporation might in one case be unobjectionable and in another case might be subject to being set aside on the application of a minority stockholder". (Id., at 642.) The opinion then presents an analysis of the transaction, indicating the basis for determining that the transaction was a fair, prudent, and honest one. (Id., at 636-7 and Commission's Exhibit No. 80.)

One of the ventures in which Continental Securities Corporation was compelled to make a substantial investment was the acquisition of the collateral notes of South American Utilities Corporation.

Alexander Beverly had agreed to participate in the activities of the Fiscal Management group in consideration of the promise of the Fiscal Management group that the funds of the investment company to be acquired by the group, which turned out to be Continental Securities Corporation, would be used to aid him in a projected financial reorganization of South American Utilities Corporation.<sup>183</sup> Mr. Beverly owned or represented others who owned a substantial block of the preferred stock of this South American Utilities Corporation.<sup>184</sup>

South American Utilities Corporation had been incorporated in 1936 to acquire all the assets of Intercontinents Power Company as a result of the reorganization, pursuant to Section 77B of the Bankruptcy Act, of the latter company.<sup>185</sup> In consideration of the transfer to South American Utilities Corporation of all of the assets of Intercontinents Power Company (consisting primarily of controlling blocks of stock of public utility companies operating in Brazil, Argentina, and Chile),<sup>186</sup> South American Utilities Corporation issued to the Chase National Bank, The National City Bank, Westinghouse Electric International Company, and American Equities Company, the secured creditors of Intercontinents Power Company, a total of \$4,593,730 principal amount of its notes,<sup>187</sup> due January 1, 1938, secured by the capital stocks of its utility subsidiaries, and voting trust certificates for 56,924 shares of its common stock.<sup>188</sup> To the unsecured debenture holders of Intercontinents Power Company, South American Utilities Corporation issued 52,500 shares of its \$4 preferred stock and voting trust certificates for 45% of its outstanding common stock.<sup>189</sup>

As at December 31, 1937, South American Utilities Corporation had outstanding \$4,594,530 principal amount of its secured notes, 52,500 shares of preferred stock, and 125,206 shares of common stock which was held in a voting trust.<sup>190</sup> At this date the Chase National Bank, the National City Bank, Westinghouse Electric International Company, and American Equities Company held \$4,593,730 principal amount of the secured notes and 56,924 common stock voting trust certificates.<sup>191</sup> As has been stated, Mr. Beverly owned or represented the owners of approximately 10,000 shares of the preferred stock of South American Utilities Corporation.

<sup>183</sup> *Id.*, at 601.

<sup>184</sup> *Id.*, at 517-8.

<sup>185</sup> *Moody's Manual of Investments, Public Utilities*, 1938, at 2157.

<sup>186</sup> *Ibid.* The principal subsidiaries acquired by South American Utilities Corporation from Intercontinents Power Company were Cia. Sud Americana de Servicios Publicos, S. A., of Argentina; Cia. Sul Americana de Servicios Publicos, S. A., and Cia. Santa Meriense de Luz Electrica, S. A., of Brazil; and Cia. Electrica de Curico, S. A., of Chile. (*In the matter of South American Utilities Corporation*, 2 S. E. C. 314 [1937].)

<sup>187</sup> The notes were to bear interest at the rate of 2% per annum plus an additional 5% per annum if earned. (*Moody's Manual of Investments, Public Utilities*, 1938, at 2158.)

<sup>188</sup> *Op. cit. supra*, note 1, at 516 and Commission's Exhibit No. 67.

<sup>189</sup> *Moody's Manual of Investments, Public Utilities*, 1938, at 2158.

<sup>190</sup> *Op. cit. supra*, note 1, at 516.

<sup>191</sup> *Ibid.*

At the close of 1937, the financial condition of South American Utilities Corporation was "very cloudy." Mr. F. P. Ohlmuller, a statistician employed by the Manufacturers Trust Company, which, as will be described later, had been requested, in connection with this South American Utility Corporation transaction, to loan \$1,800,000 to Reynolds Investing Company, Inc., one of the investment companies subsequently acquired<sup>192</sup> by the Fiscal Management group, testified:<sup>193</sup>

A. My study [of South American Utilities Corporation] was based on the report, a very exhaustive report made by a Mr. Horn,<sup>194</sup> who, I believe, was then president of the South American Utilities Corporation. This report, as I said was very exhaustive, and after making a comprehensive study of it, I came to the conclusion that under no circumstances was the South American Utilities Corporation in a position to support or justify a loan as requested, from the Manufacturers Trust Company.

Q. That is your conclusion. What did you predicate your conclusion on?

A. My conclusion was predicated on two major points. First, the financial situation, the company's earnings, rather the earnings of the three major subsidiaries in South America. They were, to my mind, not only insufficient, but probably not exactly just as stated. In other words, we did not have sufficient information as to the exact source of earnings, the amount of depreciation and maintenance to be charged off; also we did not have sufficient information with regard to the physical properties of the various subsidiaries concerned; but from the figures on hand we concluded that the earnings were wholly insufficient to support such a loan and that the financial condition of the company in general was, to our mind, at least very cloudy.

\* \* \* \* \*

A. As I have said before, there were two major points for us to take into consideration; first, the financial aspect, the second was the political aspect involved. As you probably see in this report, the company was laboring under great difficulties in its operations, because they had to compete with so-called cooperatives, utilities operating in certain communities, financed by public funds, and these cooperatives not only used the regular—you might call it fair means of competitive enterprise, but they would go ahead and force merchants—that is all in accordance with the report of Mr. Horn—force merchants and other enterprises in the respective communities to take power from these particular cooperatives rather than from the private companies, in this case the subsidiary of the South American Utilities, by threat of boycotting their business, and other means of forcing these companies to take power from these companies rather than from the subsidiaries. That alone led us to believe that the company was operating under great handicaps, and possibly could not hope to obtain fair income under the circumstances.

In 1937 the Chase National Bank and the other holders of the secured notes of South American Utilities Corporation were apparently not unwilling to dispose of their notes at a substantial discount from their principal amount. In April 1937, Mr. Beverly approached the Chase National Bank; represented that he owned a substantial interest in the preferred stock of South American Utilities Corporation,<sup>195</sup> and stated that he was interested in "buying the

<sup>192</sup> See *infra*, p. 414 et seq.

<sup>193</sup> *Op. cit. supra*, note 1, at 1383-4, 1386-7.

<sup>194</sup> *Id.*, Commission's Exhibit No. 127.

<sup>195</sup> *Id.*, at 517-8.

position of the secured noteholders," in order to "protect his investment in the preferred stock."<sup>196</sup> The Chase National Bank gave Mr. Beverly "up-to-date figures" on the financial status of the company, prepared by Mr. Van Horn, whose report, as indicated above, later proved to be the basis for the determination by the Manufacturers Trust Company that the financial status of South American Utilities Corporation could not sustain a loan of \$1,800,000.<sup>197</sup> At this time Mr. Beverly did not purchase the notes from the Chase National Bank and its associates.<sup>198</sup>

Thereafter the South American Utilities Corporation entertained an offer of the Societe Generale Pour L'Industrie Electrique, a Swiss company, for the purchase of some of the collateral which secured the debentures. This offer, which the noteholders were willing to accept, provided that, among other things, they were to receive \$2,235,000.<sup>199</sup> However, Mr. Beverly who, as indicated above, represented a substantial preferred position in the company, opposed the plan, and it was not adopted since the approval of the required number of preferred stockholders was not obtained at the meeting of October 8, 1937.<sup>200</sup>

On October 14, 1937, a day after the offer of the Swiss company was definitely terminated, presumably as a result of Mr. Beverly's opposition thereto, the Chase National Bank was again approached by Mr. Beverly who offered to purchase approximately \$4,600,000 principal amount of the notes of South American Utilities Corporation for \$2,400,000.<sup>201</sup> Mr. Beverly's purpose was to effect a reorganization of the capital structure of South American Utilities Corporation, and in order to accomplish this objective he apparently felt it necessary to acquire the existing outstanding notes of South American Utilities Corporation. Mr. Beverly, however, did not possess the cash necessary to effect the purchase of the debentures.<sup>202</sup>

Meanwhile, however, Mr. Beverly had met several of the members of the Fiscal Management group and had arranged to participate with them in the acquisition of control of an investment company whose assets could be used to supply the funds necessary to purchase the notes of South American Utilities Corporation. The arrangement between Mr. Beverly and the Fiscal Management group was that Mr. Beverly would supply \$500,000<sup>203</sup> and the investment company to be acquired would supply \$2,000,000 toward the purchase of the notes of South American Utilities Corporation. Thereafter, South American Utilities Corporation was to be reorganized by scal-

<sup>196</sup> Id., at 523.

<sup>197</sup> See supra, p. 400.

<sup>198</sup> Op. cit. supra, note 1, at 518.

<sup>199</sup> Id., at 518-9.

<sup>200</sup> Ibid. In July the company mailed a copy of the Swiss company's plan to the shareholders. The plan called for a shareholders' meeting on August 27, 1937. They met on that date, but the meeting was adjourned to October 8, 1937. At that meeting approximately 7,800 shares of the preferred stock voted in favor of the plan, which was not enough, since it required approval by two-thirds of the preferred stockholders, or 35,000 shares. (Id., at 519.)

<sup>201</sup> Id., at 520.

<sup>202</sup> Id., at 523. L. W. Snow, a vice president of the Chase National Bank, testified that "he [Beverly] told us frankly that he did not have a sufficient amount of money to buy it [the notes] but that he could arrange for the financing locally in Canada". (Ibid.)

<sup>203</sup> Mr. Beverly, however, never advanced the \$500,000. (Id., at 604.)

ing its funded indebtedness to \$2,800,000. The existing preferred stockholders of the company were to receive one share of the preferred and a half share of the common stock of the reorganized company, and Fiscal Management Company, Ltd., and Mr. Beverly each were to acquire one-half of the balance of the common stock. The investment company to be acquired was to receive for its advance of \$2,000,000 the entire \$2,800,000 principal amount of the notes of the new company and a block of its preferred stock.<sup>204</sup>

By October 20, 1937, the Fiscal Management group had virtually completed negotiations to acquire control of Continental Securities Corporation, the investment company whose assets it was contemplated would be used to further the plan of Mr. Beverly and the Fiscal Management group with reference to South American Utilities Corporation.

On October 20, 1937, Mr. Beverly had contracted to purchase through his personal holding company, National Construction Company, Ltd.,<sup>205</sup> from the Chase National Bank, the National City Bank, Westinghouse Electric International, and American Equities Company, \$4,593,730 face amount of the 4% secured notes of South American Utilities Corporation for \$2,400,000.<sup>206</sup> The contract provided for a down payment of \$25,000 on October 27, 1937, and the payment of the balance of \$2,375,000 within 30 days.<sup>207</sup>

On October 25, 1937, the Chase National Bank was requested to extend the closing date of the contract to October 30, 1937.<sup>208</sup> On that date, five days after the Fiscal Management group had acquired control of Continental Securities Corporation, the contract which had been made between National Construction Company, Ltd. (the personal holding company of Mr. Beverly), and the holders of the collateral notes, was transferred to Fiscal Management Company, Ltd.<sup>209</sup> On that same day, Continental Securities Corporation, controlled by Fiscal Management Company, Ltd., advanced to Mr. Beverly \$25,000 to meet the first payment on the contract with the Chase National Bank and the other sellers of the collateral notes of South American Utilities Corporation.<sup>210</sup>

On November 29, 1937, when the balance of \$2,375,000 was due on the contract to purchase the notes of South American Utilities Corporation, Continental Securities Corporation advanced to National Construction Company, Ltd. \$100,000 which was paid to the Chase National Bank and its associates on the contract, and the time for payment of the balance was extended so that Mr. Beverly would have to pay \$100,000 on December 9, 1937, \$200,000 on December 30, and the balance of the contract price on January 31, 1938.<sup>211</sup>

The payments due on December 9 and December 30 were duly met with funds supplied by Continental Securities Corporation so that,

<sup>204</sup> Id., at 601-3.

<sup>205</sup> Id., at 520.

<sup>206</sup> Id., at 516, 520-1 and Commission's Exhibit No. 67.

<sup>207</sup> Id., at 522 and Commission's Exhibit No. 64.

<sup>208</sup> Id., Commission's Exhibit No. 69.

<sup>209</sup> Id., Commission's Exhibit No. 64.

<sup>210</sup> Id., Commission's Exhibit No. 138. On November 5, 1937, the board of directors of Continental Securities Corporation authorized that investment company to make advances to Alexander B. Beverly in connection with the purchase of notes of South American Utilities Corporation. (Ibid.)

<sup>211</sup> Id., at 525.



as of January 1, 1938, a total of \$425,000 of the funds of Continental Securities Corporation<sup>212</sup> had been paid to the Chase National Bank and its associates on account of the purchase price of the South American Utilities Corporation collateral notes.

Subsequently, on January 31, 1938, Mr. Beverly again requested an extension to February 1, 1938 for the payment of the balance.<sup>213</sup> On February 1, 1938, however, Mr. Beverly was still apparently unable to obtain the balance of the funds to meet his commitment, and requested an extension to February 4, 1938, which was granted to him on the payment of an additional \$22,000 which was actually supplied by Continental Securities Corporation.<sup>214</sup> At this point, all of the available funds of Continental Securities Corporation had been exhausted by the purchase of the preferred stock of Fiscal Management Company, Ltd., the purchase of control of Corporate Administration, Inc., the purchase of the control of Reynolds Investing Company, Inc., the purchase of the stock of Barkley-Grow Aircraft Corporation, and the loans to members of the Fiscal Management group.<sup>215</sup>

Accordingly, on February 4, 1938, representatives of the Fiscal Management group (who in the meantime had acquired control of Reynolds Investing Company, Inc. by the use of the funds of Continental Securities Corporation) requested the Chase National Bank to lend Reynolds Investing Company, Inc. the \$2,000,000 necessary to meet the commitment of Mr. Beverly's company, National Construction Company, Ltd., to purchase the notes of South American Utilities Corporation. The Manufacturers Trust Company had previously refused to make the loan to Reynolds Investing Company, Inc.,<sup>216</sup> on the ground that the financial condition of South American Utilities Corporation, the notes of which corporation were to be deposited as collateral for the loan, was not such as to justify the loan, even after the proposed reorganization of its capital structure. Mr. Ohlmuller, a statistician employed by the Manufacturers Trust Company, testified:<sup>217</sup>

Q. Had they told you that there was contemplated a plan of reorganization whereby they were going to reduce the funded debt [of South American Utilities Corporation] from \$4,800,000 to either \$3,000,000 or \$2,000,000?

A. That was mentioned during the negotiation.

Q. And even on the basis of a funded debt of \$2,000,000?

A. That was my conclusion.

Q. Did you conclude that the valuations of the properties [of the subsidiaries of South American Utilities Corporation] were such that they would sustain any loan, or a loan of that size?

A. I would say that they would not sustain a loan of that size.

The Chase National Bank refused to make the loan upon the ground that it was the trustee under the indenture under which the debentures of the Reynolds Investing Company, Inc., were issued and that a sale of the South American Utilities collateral notes by the Chase National Bank and associates to Reynolds Investing Com-

<sup>212</sup> Id., at 524-5 and Commission's Exhibit Nos. 70-72.

<sup>213</sup> Id., at 526.

<sup>214</sup> Id., at 527.

<sup>215</sup> These transactions will be discussed *infra*.

<sup>216</sup> *Op. cit. supra*, note 1, at 1383.

<sup>217</sup> Id., at 1384.



pany, Inc., would involve some element of "self-dealing."<sup>218</sup> The Chase National Bank and associates granted to Mr. Beverly a further extension to February 11, 1938.<sup>219</sup> On that date, Mr. Beverly informed the Chase National Bank that he could not fulfil his contract, and signed certain documents purporting to terminate the contract and relieve the bank and its associates from all liability on the contract. As a result, the Chase National Bank and its associates retained not only all of the South American Utilities collateral notes, but also the \$447,000 of the funds of Continental Securities Corporation which they had received as partial payments on the contract of purchase. The Continental Securities Corporation, on the other hand, did not receive a single security for its \$447,000. L. W. Snow, a vice president of the Chase National Bank, when examined on this transaction, testified:<sup>220</sup>

Q. So that the upshot of this transaction was that you made an agreement with Mr. Beverly of the National Construction Company, Ltd., to sell them \$4,000,000 of these secured notes for two and one-half million dollars; he paid you \$447,000, and the Chase National Bank got \$447,000 and did not turn over to anybody under that contract a nickel's worth of securities, isn't that so?

A. That is correct.

The Chase National Bank, trustee of the Reynolds Investing Company, Inc. debentures and one of the owners of the South American Utilities Corporation collateral notes, refused to make the \$2,000,000 loan to Reynolds Investing Company, Inc., to enable that investment company to buy these notes, upon the ground that a conflict of interest existed. However, the Chase National Bank was also the indenture trustee of the outstanding debentures of Continental Securities Corporation and in that capacity had become aware in November 1937 that Mr. Beverly and his associates had acquired control of Continental Securities Corporation. Nevertheless, despite the fact that the bank stood in a fiduciary relationship to the holders of the debentures of Continental Securities Corporation and knew that Mr. Beverly was personally without the funds<sup>221</sup> necessary to purchase the South American Utilities Corporation notes, the Chase National Bank made no investigation during the period of time that Mr. Beverly made the payments totaling \$447,000 on account of his commitment to purchase the South American Utilities Corporation notes, to ascertain whether or not Mr. Beverly had derived these funds from Continental Securities Corporation. Mr. Snow testified:<sup>222</sup>

Q. Now, what were the duties of the Chase Bank as Trustee for the Continental Securities Corporation?

A. That is a matter with which I am not personally familiar. That is a Trust Department function, and I have not examined that indenture.

Q. Was the Chase National Bank conscious of the fact that control had passed in October to the Beverly group?

A. They were conscious of it some time after the passing in 1937; I cannot tell you whether it was in October or November.

<sup>218</sup> Id., at 531.

<sup>219</sup> Id., Commission's Exhibit No. 73.

<sup>220</sup> Id., at 528-9.

<sup>221</sup> See note 202, *supra*.

<sup>222</sup> Op. cit. *supra*, note 1, at 534-6.

Q. But you were conscious of the fact that Beverly was associated with the Continental Securities Corporation prior to the time that he made some of those payments, were you not?

A. I think the bank had that information.

Q. And the Bank, knowing that Beverly was connected with the Continental Securities Corporation, took these checks from Mr. Beverly on account of the contract for South American Corporation, and made no investigation to ascertain where Mr. Beverly was getting the money, whether he was getting it from Continental Securities Corporation?

A. There was no reason why the bank should——

Q. First tell me whether they did and then you can give me your explanation.

A. Well, that is quite true——

Q. They made no investigation?

A. They made an investigation on March 3rd——

Q. No; I am talking of investigation to find out whether those checks were coming from the Continental.

A. That contract was examined very carefully, and I am sure that there was no money—we did not go beyond the checks themselves.

Q. I am sure that the Chase Bank would not take any phony checks; I know that. But what I am trying to ascertain, Mr. Snow, is here control had passed, and Continental had sent out an announcement that the Beverly group and his Canadian associates were now in control of the Continental Securities Corporation; that is so, isn't it?

A. That is correct.

Q. And after that announcement, Mr. Beverly continued making payments of \$100,000, \$100,000, \$200,000, \$25,000, and the Chase National Bank, being trustee under the indenture of the Continental Securities Corporation, never called the officers and directors of Continental Securities Corporation, to ask them whether they were furnishing the money to Mr. Beverly, did they?

A. They did not, and there was no reason in the world why they should.

Q. You were trustee of the debentures of the Continental Securities Corporation: what were your duties, do you know?

A. That question concerns the language of the indenture, and that I am not familiar with.

When examined as to the bank's fiduciary obligation to the debenture holders of Continental Securities Corporation and the possible conflict of interest between the bank and that corporation, Mr. Snow testified: <sup>223</sup>

Q. It appears from the minutes, then, that virtually all the money that the Chase and this group received in payment on the contract that was made with the National Construction Company, Ltd., which is Mr. Beverly's company, must of necessity have come from the Continental Securities Corporation which has not received one nickel of the securities, isn't that so?

A. That is not a matter of our knowledge.

Q. I am not saying it was, but that is the fact today, isn't it?

A. That appears to be true, yes.

Q. Now why did the Bank or the debenture holders refuse to make the loan to Reynolds Investing Company, Inc., do you remember?

A. Yes, the Chase National Bank was unwilling to loan Reynolds [Investing Company, Inc.] because it was the trustee of the Reynolds [Investing Company, Inc.] debentures.

<sup>223</sup> Id., at 530-3.

Q. And therefore you felt you had some duty to the debenture holders because thereby you would then be on both sides of the transaction, namely as trustee, at least participating in the purchase by the Reynolds Investing Company, Inc. and on the other side of the table you were the seller of the South American Utilities Corporation notes, is that it?

A. That is correct. We thought there would be a decided conflict of interest.

Q. The fact of the matter is, Mr. Snow, that the Chase National Bank was also the trustee under the indenture for the funded debt of the Continental Securities Corporation, isn't that so?

A. That is correct.

Q. Of course you say that at the time you made this transaction, you did not know this money was coming from Continental Securities Corporation; is that it?

A. That is correct, and we did not know it until after the transaction was entirely finished.

Q. You know now that the Chase National Bank as trustee of the debentures of the Continental Securities Company was, in effect, although maybe not known to the bank, dealing with itself when it sold those securities ostensibly to Beverly, isn't that so?

A. We had absolutely no relations with the Continental or with Fiscal Management. It was entirely with Mr. Beverly personally.

Q. I understand that. But there came a time that you felt there would be a conflict of interest, if you permitted the Reynolds Investing Company, Inc., to buy the South American Utilities debentures, because you were trustee under the indenture of Reynolds Investing Company, Inc.?

A. That is right, and we did not deal with them.

Q. But the fact of the matter is that you did deal with the Continental Securities Corporation, although you say that at the time you did not know it.

A. No, I don't agree with that \* \* \* We had no dealings with Continental Securities Corporation at any time.

Q. I say that you did not know you were dealing with the Continental at the time you were dealing with Mr. Beverly and giving him the extensions and receiving the checks, and you did not know that he was getting the money from the Continental Securities Corporation for which you were the trustee.

A. That is quite possible.

Q. And the same conflict of interest was there, I understood you to say, but that you were unmindful of it; isn't that so?

A. We knew absolutely nothing about it.

Q. But the Chase still retains the money; isn't that so?

A. The noteholders retained the money.

Q. And still retains the securities?

A. That is correct.

Q. But you now know the money came from Continental Securities Corporation?

A. That is correct.

Q. And you know then, of course, that you were the trustees for the Continental Securities Corporation?

A. That is correct.

In addition to the loss of \$447,600 suffered by Continental Securities Corporation as a result of the South American Utilities Corporation transaction, large losses were also incurred by the investment company on "loans" made to various members of the Fiscal Management group.

Continental Securities Corporation advanced \$160,000 without collateral to Calmur & Company, Inc. Of this amount, \$100,000 was

turned over directly to Jerome C. Brady, of Prentice & Brady,<sup>224</sup> who used \$80,000 to purchase a seat on the New York Stock Exchange for J. Paul Lynch, who became a partner of Prentice & Brady.<sup>225</sup> The balance of \$20,000 was turned over to George H. Clayton, Jr., by Prentice & Brady.<sup>226</sup> When examined with respect to this advance by Continental Securities Corporation to Prentice & Brady, George J. Mitchell, one of the group, testified.<sup>227</sup>

Q. Now, when the \$160,000 loan was made to Calmur, out of which \$100,000 was turned over to Prentice & Brady, did you get an assignment of the Stock Exchange seat?

A. I never saw any of the assignments on that.

Q. Did you ever get a piece of paper, a promissory note, for that loan?

A. Yes; I understand there was a promissory note.

Q. Was that carried in the account just as an account receivable?

A. It was carried on the books as an account receivable.

Q. It was a promissory note, but the promissory note was not made to Continental Securities Corporation.

A. No; it was not.

Q. And the Continental Securities Corporation never got a promissory note signed by Prentice & Brady or Lynch, did they?

A. No.

The remaining \$60,000 of the \$160,000 advance to Calmur & Company, Inc. was "advanced in various small amounts" to "various persons."<sup>228</sup> There is no evidence that any part of this \$160,000 was ever repaid to the Continental Securities Corporation.

The remainder of the portfolio securities which were in the Continental Securities Corporation account opened with Prentice & Brady, then members of the New York Stock Exchange, were liquidated. Prentice & Brady received \$48,000 as brokerage fees in connection with the sale of these securities.<sup>229</sup> From the proceeds of the sale of these securities, approximately \$102,750 of the funds of Continental Securities Corporation were invested in stock of Barkley-Grow Aircraft Corporation, the remainder of its \$250,000 issue, which had been underwritten by Fiscal Management Company, Ltd.<sup>230</sup> In addition, \$182,500 of the funds of Continental Securities Corporation was used to purchase from First Income Trading Corporation 1,825 shares of the \$100 par value preferred stock of Fiscal Management Company, Ltd.,<sup>231</sup> increasing the holdings of Continental Securities Corporation in the preferred stock of Fiscal Management Company, Ltd., to 8,825 shares, at an aggregate cost of \$882,500.

Practically all of the remaining assets of Continental Securities Corporation were utilized by the Fiscal Management group in connec-

<sup>224</sup> Id., at 587-8.

<sup>225</sup> Ibid.

<sup>226</sup> Id., at 588.

<sup>227</sup> Id., at 589-90.

<sup>228</sup> Id., at 588-9. Mr. Mitchell who testified with respect to this distribution of the \$160,000 could not recall the names of the persons to whom these advances were made.

<sup>229</sup> Id., at 593.

<sup>230</sup> Id., at 591 and Commission's Exhibit No. 138. It will be recalled that Barkley-Grow Aircraft Corporation was the company with which Mr. Grow, one of the sponsors of First Income Trading Corporation, was associated. (See *supra*, pp. 367-8.)

<sup>231</sup> Id., at 580.

tion with their acquisition of control of other investment companies. Approximately \$350,000 of the assets of Continental Securities Corporation were used to purchase control of Corporate Administration, Inc., which held the management and distribution contract with Administered Fund Second, Inc., an open-end investment company.<sup>232</sup> Approximately \$1,500,000 of the funds of the Continental Securities Corporation was used to purchase from C. K. Reynolds, the members of his family and associates, the controlling block of common stock of Reynolds Investing Company, Inc., another investment company.<sup>233</sup>

Thus within the period of only five months (October 1937 to March 1938) during which the Fiscal Management group was in control of Continental Securities Corporation, practically the entire portfolio of that investment company, valued at \$3,300,000, was liquidated and the proceeds disbursed in the following securities or transactions: \$882,500 was used to purchase 8,825 shares of preferred stock of Fiscal Management Company, Ltd., whose only asset consisted of the control blocks of stock of First Income Trading Corporation and Continental Securities Corporation; \$102,750 was invested in the stock of Barkley-Grow Aircraft Corporation; \$447,000 was paid on the contract to purchase the collateral notes of South American Utilities Corporation, and entirely lost; \$160,000 constituted an outright loan to Prentice & Brady and "others", which has apparently not been repaid; approximately \$1,500,000 was used to acquire a controlling interest in Reynolds Investing Company, Inc.; and \$354,000 was used to acquire control of Corporate Administration, Inc.

In March 1938, Continental Securities Corporation was placed in reorganization under Section 77B of the Bankruptcy Act.<sup>234</sup>

#### 4. ACQUISITION OF CONTROL OF CORPORATE ADMINISTRATION, INC.

As has been indicated, the funds of Continental Securities Corporation were used by the Fiscal Management group to acquire control of other investment companies, including Corporate Administration, Inc. After Messrs. Frear, Clayton, and Ferretti and their associates had completed the acquisition of Continental Securities Corporation, Mr. Beverly, as the president of Fiscal Management Company, Ltd., on November 15, 1937, authorized Mr. Ferretti to continue to negotiate for the purchase of control of investment companies of the general management type, subject to the approval of the board of directors of Fiscal Management Company, Ltd.<sup>235</sup> Mr. Ferretti, with the approval of Mr. Beverly, requested the accounting firm of Hyslop

<sup>232</sup> See *infra* for discussion of acquisition of control of Corporate Administration, Inc.

<sup>233</sup> See *infra* for discussion of acquisition of control of Reynolds Investing Company, Inc.

<sup>234</sup> Judge Robert P. Patterson of the United States District Court for the Southern District of New York appointed as trustee Arthur A. Ballantine. His action followed a request for reorganization of the company, filed with him on March 17, by three holders of the investment company's 5% 15-year debentures who charged that the company was insolvent, and the issuance of an injunction restraining the management from disposing of the assets of the company. (*The New York Times*, March 25, 1938, p. 27.)

<sup>235</sup> *Op. cit. supra*, note 1, at 609-10 and Commission's Exhibit No. 76.

and Boehm to make a study "in a quiet manner"<sup>236</sup> of investment companies available for purchase. Mr. Boehm of that firm asked one Cleveland Storrs<sup>237</sup> and one Franklin E. Mayer<sup>238</sup> to assist him in finding such investment companies.

Mr. Storrs recommended to Mr. Ferretti several investment companies which he thought might be acquired by the Fiscal Management group. Among these companies were Overseas Securities Co., Inc., American International Corporation, and Corporate Administration, Inc. The Fiscal Management group were unsuccessful in their negotiations to purchase Overseas Securities Co., Inc., because Morton H. Fry, president of Overseas Securities Co., Inc., refused to sell control of this investment company unless, among other things, the same offer be made to the minority stockholders as was being made to the controlling stockholders.<sup>239</sup> Mr. Fry testified:<sup>240</sup>

Q. You say the three conditions you imposed were, first, you wanted to know who the principal was; second, you wanted some definite assurance that the basic nature of the trust would not be changed; and thirdly, they had to make the same offer to the minority stockholders they were making to the majority stockholders?

A. That is correct.

Q. What impelled you to impose those conditions; I mean, did you mean that the officers and directors and sponsors of this trust owed it to the minority stockholders?

A. My firm and my associates and the directors were personal friends of mine, and we had been connected with this trust since the beginning. We felt a certain sense of trusteeship, and that it was an utterly unfair thing to sell the stockholders or bondholders down the river.

The management of American International Corporation likewise refused to sell control of that company because they were not satisfied with the financial responsibility of the alleged principals whom Messrs. Storrs, Prentice, and Boehm represented.<sup>241</sup> Mr. Mitchell testified:<sup>242</sup>

A. \* \* \* it wound up by Mr. Boehm and Mr. Prentice agreeing to submit a list of the principals involved in this \$3,000,000 purchase, which was to be the total of the shares of stock which Adams owned, plus the stock owned by Solvay American Investment, which totaled approximately 260,000 shares, and it in-

<sup>236</sup> Id. at 1394, 1938. Mr. Boehm testified (id., at 1398-9):

Q. What was the necessity of secrecy? Did he tell you why he wanted it quiet?

A. Yes; due to the fact that there was a good many people, I presume, running around the street and competing, I presume, with one another, with any principal.

This competition for the acquisition of investment companies is exemplified by the experience of Morton H. Fry, president of Overseas Securities Co., Inc. He testified (id., at 439):

Q. Do you recall in the latter part of last year [1937] you were being approached with respect to the possibility of transferring control of Overseas Corporation to a group of individuals?

\* \* \* \* \*

A. Well, we were approached so many times about that that I finally began to feel as though I ought to have a bodyguard \* \* \*.

<sup>237</sup> Id., at 1399-1400.

<sup>238</sup> Ibid.

<sup>239</sup> Id., at 438-47.

<sup>240</sup> Id., at 446-7.

<sup>241</sup> Id., at 448-61.

<sup>242</sup> Id., at 458-9.

volved a total purchase price of about \$3,000,000, and they were to give us the names of the principals and the amount which each principal was to put up, not borrowed money, but actual funds which each individual was to advance out of his own personal fortune.

It took them a couple of days to get that letter over to us \* \* \*.

\* \* \* \* \*

Q. I notice the individuals are Leon McCormack, James A. Frear, Harry Curtis, Fred Ross, A. B. Beverly, S. Prentice \* \* \*.

A. \* \* \* We did not consider that letter a satisfactory reply to our request. On that same afternoon, Monday afternoon, December 13th, at our board meeting, we informed the board what had taken place, we were quite sure that the names submitted were not the ultimate principals, and therefore we would discontinue any further conversations with Mr. Prentice or Mr. Conroy, or anyone else involved in the matter.

To demonstrate to the management of American International Corporation that the alleged principals who were negotiating for the purchase of control of American International Corporation were financially responsible, the Fiscal Management group negotiated for and succeeded in acquiring control of Corporate Administration, Inc.<sup>243</sup> Mr. Mitchell testified:<sup>244</sup>

Q. What did Mr. Boehm and Mr. Mayer say with respect to Corporate Administration?

A. They told us they were acquiring Corporate Administration because they wanted to show some people who they were dealing with that they were able to buy it, put the idea over and then they could get the American International deal.

Q. Did Mr. Mayer and Mr. Boehm say that they were not interested in Corporate Administration as a business acquisition, but merely as a sort of a front with the people who were buying American International, that they have a lot of money and that is the reason they were buying Corporate Administration, is that it?

A. That is right.

Corporate Administration, Inc., which had been formed by Gilbert Ottley and Robert Strange to organize, administer, and distribute securities of investment companies,<sup>245</sup> issued 5,000 shares of common stock without par value to Messrs. Ottley and Strange for a total consideration of \$35,000.<sup>246</sup> The sponsors of Corporate Administration, Inc., had organized under the laws of Delaware on August 21, 1934, an open-end investment company known as Administered Fund Second, Inc.,<sup>247</sup> and held the management and distribution contracts with this investment company.<sup>248</sup> Although the formulation of the investment policy of Administered Fund Second, Inc., had been delegated

<sup>243</sup> Id., at 607, 1598.

<sup>244</sup> Id., at 598-9.

<sup>245</sup> Id., at 540-43. Although Corporate Administration, Inc., had been organized to perform these activities for investment companies throughout its existence, it was only affiliated with Administered Fund, Inc., and Administered Fund Second, Inc., which "was organized to pull them out of Administered Fund, Inc." (Id., at 1102.) The capital structure of Corporate Administration, Inc., consisted of 5,000 shares of common stock and 4,300 shares of preferred stock.

<sup>246</sup> Gilbert Ottley held 2,550 shares of common stock and a certificate for 4,300 shares of the preferred stock. (Id., Commission's Exhibit No. 130.) Robert Strange held 2,450 shares of common stock. (Id., Commission's Exhibits Nos. 130, 132.)

<sup>247</sup> Id., at 1297; *Moody's Manual of Investments, Banks, etc.*, 1937, at 1361.

<sup>248</sup> Id., at 1298.

to Young & Ottley, an investment counsel firm, and later to the investment counsel firm of H. W. Grindal & Co., Inc.,<sup>249</sup> the holders of the control block of stock of Corporate Administration, Inc. were the ultimate arbiter of the management of this investment company.<sup>250</sup> The management contract held by Corporate Administration, Inc. constituted the medium through which the investment policy of Administered Fund Second, Inc. might be controlled.<sup>251</sup> Mr. Ottley conceded that the only assets of Corporate Administration, Inc. were its management and distributing contracts with Administered Fund Second, Inc.<sup>252</sup>

Q. \* \* \* Fundamentally, Corporate Administration, Inc., is nothing but a corporate shell. It is engaged in the business of acting as principal distributor of the securities of Administered Fund Second, Inc.?

A. No; I would not call it a corporate shell, because it had very definite obligations that it contracted for, for which it was paid, and which it in turn delivered.

Q. Well, anyway, the business of Corporate Administration, Inc., is one of acting as principal distributor for shares of an Investment Trust called Administered Fund Second, Inc.—isn't that so—and acting as manager for that fund?

A. To supply investment management for that company, to supply and pay for all the officers, directors, and the expenses, with the exception of taxes.

Q. \* \* \* accepting your qualification, its business is substantially to administer the fund and act as its distributor?

A. Yes; with my qualification.

By November 1937, when the Fiscal Management group acquired control of Corporate Administration, Inc., and through it, control of Administered Fund Second, Inc., the latter's assets totaled \$3,462,302,<sup>253</sup> although the net contribution which had been made to the company by its stockholders had been approximately \$4,700,000.<sup>254</sup> In other words, the company's assets during its management by Corporate Administration, Inc., had suffered a depreciation of approximately \$1,225,000.

Corporate Administration, Inc., within the two-year period it had managed and distributed the securities of Administered Fund Second, Inc., had derived a profit of only \$4,887.83, all of which was earned in 1937.<sup>255</sup> For the year 1936, Corporate Administration,

<sup>249</sup> Ibid.

<sup>250</sup> Id., at 1300. Those in control of Corporate Administration, Inc., could, however, choose to make investments for Administered Fund Second, Inc., without the approval of the independent investment counsel, whose only recourse was to resign.

<sup>251</sup> Edward G. Leffler testified (id., at 1300):

Q. The fact of the matter is, is it not, that although the Board of Directors of Corporate Administration did not make any investment without the approval of independent investment counsel, the only recourse of Young & Ottley if such an investment was made to terminate the agreement?

A. That is right.

Q. \* \* \* if somebody got control of Corporate Administration and bought stock that Young & Ottley did not approve of, the only thing Young & Ottley could do is resign?

A. Yes.

<sup>252</sup> Id., at 540-1.

<sup>253</sup> Id., Commission's Exhibit No. 64.

<sup>254</sup> The gross capital contributed to Administered Fund Second, Inc., between 1934 and November 1937 had been \$6,716,575. Over the same period, however, the company had returned to its stockholders by repurchases or redemption of its shares or by way of dividends, a total of \$2,029,605. (Ibid.)

<sup>255</sup> Id., Commission's Exhibit No. 132 (Exhibit C).



Inc. had operated not only at a loss, but Mr. Ottley was compelled to lend \$86,000 to Corporate Administration, Inc. in order to enable it to meet the expenses of qualifying the securities of Administered Fund Second, Inc. under the securities law of the various States.<sup>256</sup> In January 1937 this loan was satisfied by the issuance to Mr. Ottley by Corporate Administration, Inc. of 4,300 shares of its \$20 par value preferred stock.<sup>257</sup> By November 20, 1937, Corporate Administration, Inc. had total assets of approximately \$130,000 which included a valuation of \$50,000 for its management and security distribution contracts with Administered Fund Second, Inc.<sup>258</sup> As of that date, the operating deficit of Corporate Administration, Inc. for the entire period of its operation totaled \$113,065.66.<sup>259</sup>

During 1937, Messrs. Ottley and Strange had offered to sell all of their common stock of Corporate Administration, Inc. to Edward Leffler for \$25,000, but the sale was not consummated.<sup>260</sup> In November 1937, however, the Fiscal Management group through Franklin E. Mayer offered to purchase all of the holdings of Messrs. Ottley and Strange in Corporate Administration, Inc. for \$250,000. Mr. Ottley testified that "he was not surprised by the offer of \$250,000," although the purchasers to the knowledge of Messrs. Ottley and Strange were aware<sup>261</sup> that the sum offered was almost twice the then value of the entire assets of Corporate Administration, Inc. and that the company had been a losing venture over the entire period of its existence. On November 29, 1937 Mr. Ottley and Mr. Strange accepted this offer. Mr. Ottley received \$150,000 for his holdings of the preferred and common stock of Corporate Administration, Inc. and Mr. Strange received \$100,000 for his common stock in that company.<sup>262</sup> The total consideration of \$250,000 received by Messrs. Ottley and Strange was \$129,000<sup>263</sup> in excess of their aggregate investment in Corporate Administration, Inc.<sup>264</sup>

Control of Corporate Administration, Inc., carried with it control of the approximately \$4,000,000 of liquid assets of Administered Fund Second, Inc. Notwithstanding this fact, Messrs. Ottley and Strange made no attempt to ascertain who the actual purchasers of their hold-

<sup>256</sup> Id., at 544.

<sup>257</sup> Id., Commission's Exhibit No. 130 at 5-6.

<sup>258</sup> Id., Commission's Exhibit No. 132 (Exhibit A).

<sup>259</sup> Ibid.

<sup>260</sup> Id., at 545-6.

<sup>261</sup> Id., at 545.

<sup>262</sup> Id., Commission's Exhibit No. 130.

<sup>263</sup> The total contribution made by Messrs. Ottley and Strange to the company was \$121,000, of which \$35,000 was paid for common stock and \$86,000 for preferred stock. (Id., at 544.)

<sup>264</sup> In addition, the Fiscal Management group paid \$14,000 to Amos R. Poole, and the old management paid him \$10,400. (Id., at 1578-9.) Mr. Poole was a partner in the stock exchange firm of F. A. Willett & Co. and at that time had a contract with Mr. Ottley which provided that he would participate in a portion of the brokerage commissions which Mr. Ottley received from Administered Fund Second, Inc. (Id., Commission's Exhibit No. 145.) Subsequently Mr. Poole severed his relationship with F. A. Willett & Co., the contract was canceled (id., Commission's Exhibit No. 145) and Mr. Poole was employed by Corporate Administration, Inc. (id., at 1573), and was to be compensated on the basis of  $\frac{1}{8}$  of the gross brokerage commissions paid by Administered Fund Second, Inc. (Id., Commission's Exhibit No. 146.) In order to get Mr. Poole to release Corporate Administration, Inc., from liability under the contract, the payment of \$24,400 was made to him.

ings were. They assumed they were dealing with Franklin E. Mayer as principal.<sup>265</sup> Mr. Ottley testified:<sup>266</sup>

Q. Now, you ultimately sold control of Corporate Administration, Inc., to Continental Securities Corporation.

A. We never knew to whom it was.

Q. Whom did you sell it to?

A. I think we sold it to Mayer & Company.

However, the contract of sale by Messrs. Ottley and Strange was made with Conroy & Company as the purchaser,<sup>267</sup> but the checks received by Messrs. Ottley and Strange in payment for their stock were drawn by Calmur & Company, Inc. Despite these differences between the buyer named in the contract and the source of the payment which he received, Mr. Ottley testified that he made no attempt to investigate Calmur & Company, Inc., which had not previously been connected with the transaction.<sup>268</sup>

A. I got \$150,000 on November 29th.

Q. Whose check was it, do you remember?

A. It was drawn by Calmur & Company.

Q. Do you know who Calmur & Company was?

A. No; I didn't know who Calmur & Company was.

Q. You didn't ask about that?

A. It was a certified check and I presume that Calmur & Company is—I was told later represented other purchasers.

In fact, the contract between Conroy & Company and Messrs. Strange and Ottley for the sale of Corporate Administration, Inc., was immediately transferred to Calmur & Company, Inc., which re-assigned it to Continental Securities Corporation for \$354,000,<sup>269</sup> and Calmur & Company, Inc., the dummy corporation for some of the Fiscal Management group, took \$104,000 as a "profit." This "profit," paid by Continental Securities Corporation, controlled at the time of this transaction by the group, was divided as follows: Hyslop and Boehm, \$5,250; James Callanan, \$10,500; Clayton B. Davis, \$5,250; George H. Clayton, Jr., \$20,000; Philip A. Frear, \$20,000; and Conroy & Company, \$25,000.<sup>270</sup>

Up to the time that the various government agencies commenced their investigation of the activities of the Fiscal Management group, the assets of Administered Fund Second, Inc. had not been "touched," possibly because of the charter restrictions on the investments which might be made by this investment company,<sup>271</sup> and possibly because of the apparent opposition of Edward G. Leffler, who was distributing the

<sup>265</sup> Id., at 543.

<sup>266</sup> Ibid.

<sup>267</sup> Id., Commission's Exhibit No. 130.

<sup>268</sup> Id., at 549.

<sup>269</sup> Id., at 599-601 and Commission's Exhibit No. 138.

<sup>270</sup> Id., at 599-601; 1291-2; 1408-10; 1415; 1422-3; and Commission's Exhibits Nos. 128, 129.

<sup>271</sup> The charter of Administered Fund Second, Inc., permitted investments only in securities listed on a recognized exchange and in the securities of banks, trust and insurance companies, and obligations of the United States, the various states and their political subsidiaries. Moreover, not more than 5% of the corporation's assets could be invested in the securities of any one enterprise. (Id., Commission's Exhibit No. 116.)

securities of Administered Fund Second, Inc., under contract with Corporate Administration, Inc.<sup>272</sup>

On August 26, 1938, the trustee in reorganization of Continental Securities Corporation sold all the stock of Corporate Administration, Inc., consisting of 5,000 shares originally owned by Continental Securities Corporation, which had cost that investment company, as indicated above, \$354,000, to Edward G. Leffler for \$5,000, representing a realized loss to Continental Securities Corporation of approximately \$350,000.<sup>273</sup>

## 5. ACQUISITION OF CONTROL OF REYNOLDS INVESTING COMPANY, INC.

It will be recalled that Alexander Beverly and other members of the Fiscal Management group were desirous of acquiring the collateral notes of South American Utilities Corporation held by the Chase National Bank and its associates, effect a reorganization of that corporation, sell the notes of the reorganized company to the public, and retain a substantial part of the common stock for themselves. Although the contract with the Chase National Bank for the sale of the South American Utilities Corporation notes was made with the National Construction Company, Ltd., the personal company of Alexander Beverly, the payments of \$447,000 made on that contract of purchase came, as has been described, from Continental Securities Corporation, and a balance of \$2,000,000 still remained to be paid. Because the funds of Continental Securities Corporation had been depleted through loans to the members of the group, purchase of the Barkley-Grow Aircraft stock, purchase of the Fiscal Management Company, Ltd. preferred stock, and "commissions" and "profits" to the members of the group, Continental Securities Corporation did not have sufficient funds to pay the balance of \$2,000,000 due on the contract with the Chase National Bank. It will also be recalled that the group had made attempts to acquire control of other investment trusts, including the Overseas Securities Co., Inc. and American International Corporation. The members of the group, to impress the management of the American International Corporation with their financial responsibility and solvency, caused Continental Securities Corporation to purchase Corporate Administration, Inc. for \$354,000. However, as has been indi-

<sup>272</sup> On January 13, 1938, two months after the Fiscal Management group acquired control of Corporate Administration, Inc., Mr. Leffler in a letter to Franklin E. Mayer, who had been selected by the Fiscal Management group to be president of Corporate Administration, Inc., stated: "I am the person responsible for the sale of the great bulk of the shares of Administered Fund outstanding and I am entitled not only to know every detail about the people with whom I am dealing and all about their purposes and plans, but I should be satisfied that those people and their plans and purposes are such that I can honestly recommend them". (Id., Commission's Exhibit No. 117.)

<sup>273</sup> This sale was made pursuant to the order of the United States District Court for the Southern District of New York dated August 18, 1938. As a result, at the present time there is no connection between Continental Securities Corporation and Corporate Administration, Inc. The trustee of Continental Securities Corporation is, however, proceeding with his claim against Robert Strange and Gilbert Ottley, who received \$250,000 of the money belonging to Continental Securities Corporation when they sold Corporate Administration, Inc., in November 1937. (Letter of August 22, 1939, from Cook, Nathan, Lehman, and Greenman, attorneys for Mr. Ballantine, the trustee in reorganization for Continental Securities Corporation, to the Securities and Exchange Commission.)

cated, the attempts of the group to acquire control of Overseas Securities Co., Inc., and American International Corporation were unsuccessful. It was therefore incumbent upon the group to acquire control of some other investment companies whose funds could be used to pay the \$2,000,000 balance due on the contract of the Chase National Bank, if they were to consummate their plans of acquiring the collateral notes of the South American Utilities Corporation and effecting a reorganization of that corporation. Under those circumstances, Mr. Ferretti, in December 1937, asked Franklin E. Mayer to find some other investment companies control of which could be acquired by the group.<sup>274</sup>

Mr. Mayer "looked through" the entire investment trust section of Moody's Manual and selected Reynolds Investing Company, Inc. as the investment trust company which could be possibly acquired. Mr. Mayer testified:<sup>275</sup>

Q. What did he [Ferretti] say?

A. Well, it is pretty hard to recall what he said, but I think his actions spoke the loudest, so I went and looked through Moody's to see if I could see any trusts that were officered by men to whom I could get an introduction.

\* \* \* \* \*

Q. Did you start with the letter "A" and go right through?

A. I did. I started at the beginning of the alphabet and went clear through the end and listed four or five trusts, but none except the Reynolds could I get an introduction to them. I told Mr. Ferretti. I gave him a rough idea of what the trust was and asked him if he would be interested.

Q. That is, you got it out of Moody's?

A. I got it out of Moody's.

Reynolds Investing Company, Inc., an investment company of the general management type, had been incorporated under the laws of Delaware on March 2, 1928, by Reynolds & Company and Chas. D. Barney & Co.<sup>276</sup>

Prior to 1930, Reynolds Investing Company, Inc., had raised approximately \$9,300,000. Of this amount, \$8,300,000 had been raised through the sale of \$5,000,000 principal amount of debentures and \$3,300,000 of preferred stocks to the public. The sponsors had purchased 100,000 shares which constituted all of the outstanding common stock, for \$1,000,000.<sup>277</sup>

In 1930, Reynolds Investing Company, Inc., acquired by merger all of the assets of Reynolds Brothers, Inc., a private holding company in which R. S. Reynolds and C. K. Reynolds were the holders of the largest interest.<sup>278</sup> As a result of this merger, an additional \$6,500,000 was brought into Reynolds Investing Company, Inc., of which \$5,500,000 constituted the sponsors' contribution and \$1,000,000 the public's money.<sup>279</sup> The total capital contributed to Reynolds

<sup>274</sup> Op. cit. supra, note 1, at 1314.

<sup>275</sup> Id., at 1317-8.

<sup>276</sup> Reply to the Commission's questionnaire for Reynolds Investing Company, Inc., Pt. I.

<sup>277</sup> Reynolds & Company had purchased 75,000 shares and Chas. D. Barney & Co. had purchased 25,000 shares. By subsequent split-ups and thereafter as a result of the merger of Reynolds Investing Company, Inc., and Reynolds Brothers, Inc., the holdings of the Reynolds family in Reynolds Investing Company, Inc., were increased to approximately 1,000,000 shares. (Reply to the Commission's questionnaire for Reynolds Investing Company, Inc. (Pt. I).)

<sup>278</sup> Op. cit. supra, note 1, at 1142-3.

<sup>279</sup> Id., at 1142.

Investing Company, Inc. was therefore \$15,800,000, of which \$6,500,000 represented the investment of the sponsors and \$9,300,000 the contribution of the public.

Between 1930 and 1937 Reynolds Investing Company, Inc. returned a total of \$3,951,000 to its security holders by way of repurchases of its own outstanding securities and dividends.<sup>280</sup> As at December 31, 1937 therefore, the net capital contributed to the company by its security holders was approximately \$12,000,000, but the company had net assets of approximately \$4,900,000, after deducting all liabilities except bonded indebtedness.<sup>281</sup> In other words, the company in its operations to 1937 had suffered a realized and unrealized loss of approximately \$7,000,000.<sup>282</sup>

As at December 30, 1937 Reynolds Investing Company, Inc. had outstanding \$3,446,900 principal amount of debentures; 9,915 shares of preferred stock entitled on voluntary liquidation of the company to an aggregate preference in assets of \$1,090,650<sup>283</sup> and total accrued unpaid dividend on these preferred stocks of \$327,195; and 1,787,359 shares of common stock.<sup>284</sup> The debentures and preferred stock, including dividend arrearages, were therefore entitled to a preference over the common stocks of \$4,864,745<sup>285</sup> so that only \$60,193 of the assets of the company were available to common stockholders. Thus, as at December 30, 1937, the 1,787,359 shares of common stock had an asset value of approximately four cents a share<sup>286</sup> while the market value was 81¼ cents.

As at December 30, 1937, a majority of the outstanding common stock, which had sole voting power (approximately 1,000,000 shares), was owned by the Reynolds family and had been originally acquired by them at a cost of \$1,000,000.<sup>287</sup> At this time this block had an asset value of approximately \$40,000 and a market value of about \$812,500.

All of the directors, except one, of the Reynolds Investing Company, Inc. were members of the Reynolds family.<sup>288</sup> C. K. Reynolds was president, R. S. Reynolds was vice president, and W. F. Woodward was secretary and treasurer.

C. K. Reynolds conceded that the Reynolds family's control of a majority of the common stock of Reynolds Investing Company, Inc., their control of the directorate of the company, the association of the family name with the investment company, their sponsorship of the

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<sup>280</sup> Op. cit. supra, note 1, Commission's Exhibit No. 64. The company repurchased \$1,550,000 face value of its debentures and 20,000 shares of its preferred stock having a preference on liquidation of \$2,000,000, at an aggregate cost of \$1,274,000 for both debentures and preferred stock. (Id., at 1146-7.) The security holders who sold their debentures and preferred stock suffered a loss, measured by the difference between the asset value of their securities and the sums which they received for such securities from the corporation, of approximately \$2,300,000.

<sup>281</sup> Id., Commission's Exhibit No. 105.

<sup>282</sup> Id., Commission's Exhibit No. 64.

<sup>283</sup> The preferred stock was entitled to a preference in assets of \$110 per share on any voluntary liquidation of the company and to a preference of \$100 a share on any involuntary liquidation. (*Moody's Manual of Investments, Banks, etc.*, 1936, at 1587.)

<sup>284</sup> Id., Commission's Exhibit No. 105.

<sup>285</sup> Ibid.

<sup>286</sup> Id., at 1156.

<sup>287</sup> Id., at 1144.

<sup>288</sup> The other director was W. F. Woodward, whom Mr. Reynolds described as an "independent member of the board." (Id., at 1149.)

company, and their distribution of the company's securities created in each such relationship an obligation on the part of the Reynolds family to the debenture holders, the preferred stockholders, and the minority common stockholders of the company, who were really the owners of all but \$40,000 of investment company's assets. Mr. Reynolds testified:<sup>289</sup>

Q. Of course, it was not unlikely because the name of Reynolds was in the investment company name, that the public would associate it with the Reynolds family, that is, your own family?

A. I don't know that we were so well known.

\* \* \* \* \*

Q. The point I am trying to make is this: the fact that your name was in there, people might rely on the fact that this was a Reynolds company; isn't that so?

A. That is right.

Q. People might also rely on the fact that because of your background, integrity, and connections, that that was the type of company that they would want to be associated with; isn't that so?

A. I would think so.

Q. The fact is that we have been told repeatedly throughout the investigation that when substantial responsible firms put their names in an investment company or trust they did it intentionally with the idea of imposing upon themselves the responsibility that flows from the fact that you have your name in the name of the investment trust. Do you recognize that possibility?

A. Yes.

\* \* \* \* \*

Q. The Reynolds group always had a majority control of the voting stock, and they had that at the very inception of the company; isn't that so?

A. Yes.

Q. Do you consider, Mr. Reynolds, that you had some obligation to the senior security holders and the minority common stockholders, by virtue of the fact, first, that you had sponsored this investment company and organized it?

A. Yes; I agree with you.

Q. What did you conceive your obligation and duty were under the circumstances, aside from any legal aspects?

A. To give proper management to the company. I think our records will prove that I certainly feel that we discharged that obligation.

\* \* \* \* \*

Q. As sponsors, you had some obligation to these people to see that nothing you did would hurt their interest; is that right?

A. That is right.

Q. And then as distributors of securities, you were the principal underwriting group, were you not?

A. There was no underwriting group. There was an agency contract.

Q. I say you and your company distributed the securities to the public?

A. That is right—we and our associates.

Q. That went for the debentures as well as the preferred stock?

A. That is right.

Q. You had the same obligation to see that nothing was done to hurt these people?

A. That is right.

<sup>289</sup> Id., at 1145-6, 1149-1155.

Q. You also, at least at the inception, had a controlling block of the voting stock which cost you \$1,000,000, and the public put in \$6,000,000. Did you conceive that you had some obligation by virtue of the fact that you had the common stock and you controlled the company?

A. That is right.

Q. That created an obligation, did it not?

A. That is right.

Q. You also had a situation, did you not, that you constituted at all times—the Reynolds group—the majority of the board of directors; isn't that so?

A. (No answer.)

Q. It is true, after March 1930; isn't it?

A. I would say after 1932 anyway.

Q. At least, it was so at the time that you carried on the negotiations for the sale?

A. Oh, yes.

Q. You were the board of directors by virtue of the fact that you could vote yourself in; isn't that so?

A. Yes.

Q. You owned the majority of the controlling block?

A. That is right.

Q. Did you conceive that that created some duty or obligation to the security holders?

A. I believe so.

Q. And you were also the officers of the company?

A. Yes; that is right.

Q. And that created some obligation, did it not?

A. Correct.

\* \* \* \* \*

Q. We have the situation where you have these manifold obligations that arise from the various relationships that you had with the senior security holders and the minority common stockholders. You can visualize, can you not, Mr. Reynolds, that the people purchased those securities with the consciousness that you had these various obligations to the various senior security holders, can you not?

A. I think so.

Q. It is not repugnant to your way of thinking that a person would say, "Well, this is a Reynolds company; they are the officers, directors; they have sold the securities; they have the controlling block of stock; and they are the type of people I would like to entrust my money to." That is not an outrageous assumption, is it?

A. No.

Q. The fact is, you can visualize people doing that—isn't that so—putting reliance on those factors?

A. I think so.

\* \* \* \* \*

Q. And you can appreciate that as long as that name was there people might have a right to assume that it was still a Reynolds company; isn't that so?

A. I would think so. Of course, they would find out if they looked it up, that they would not find any Reynolds on the board of directors \* \* \*.

On December 15, 1937 Franklin E. Mayer, purporting to represent Sartell Prentice, of the New York Stock Exchange brokerage firm of Prentice & Brady, approached C. K. Reynolds to ascertain whether

the Reynolds family would sell its controlling block of the common stock of Reynolds Investing Company, Inc. Mr. Reynolds testified that he caused an investigation of the financial responsibility and integrity of Sartell Prentice to be made and ascertained that Mr. Prentice was reported to be related to the Rockefeller family and that the firm of Prentice & Brady had a "net worth of \$517,000."<sup>290</sup> The report also stated: "There were times when the firm seemed to do a pretty substantial volume on its capital, but again this may be a well-laid plan to avoid paying interest on capital funds; recognizing that Mr. Prentice is related to the Rockefeller family, the deduction seems fair that he could get additional funds in case of need."<sup>291</sup>

Although C. K. Reynolds had been informed that Mr. Prentice was the actual buyer or principal,<sup>292</sup> on December 31, 1937 the Reynolds family agreed<sup>293</sup> to sell to Franklin E. Mayer, as the ostensible purchaser, between 1,035,000 and 1,055,000 shares of the common stock of Reynolds Investing Company, Inc. at \$2 a share, for a total price of between \$2,070,000 and \$2,110,000, payable in installments of \$1,499,734 on December 31, 1937, the closing date of the contract, \$392,756 on or before January 3, 1938, and \$217,510 on January 12, 1938.<sup>294</sup> Eventually, the Reynolds family obtained \$2,110,000 for their holdings of Reynolds Investing Company, Inc. common stock which had cost them approximately \$1,000,000 and which had, as at the date of the sale, a market value of approximately \$812,500 and an asset value of \$40,000.

On December 31, 1937, Prentice & Brady delivered a check for \$1,499,434 to the Reynolds family and received 749,867 shares of the common stock of Reynolds Investing Company, Inc.<sup>295</sup> The source from which Prentice & Brady derived these funds will be described later. Notwithstanding the fact that on this date Prentice & Brady had paid only a portion of the purchase price, and that they held only a minority block of the common stock of Reynolds Investing Company, Inc. and were still obligated to pay a balance in excess of \$500,000 on the contract,<sup>296</sup> all of the members of the board of directors of Reynolds Investing Company, Inc. resigned and were replaced by Prentice & Brady's nominees<sup>297</sup> through the device of alternate resignations and elections of members of the board.

Thus the Reynolds family turned over control of the Reynolds Investing Company, Inc., with its approximately \$5,000,000 of assets,

<sup>290</sup> Id., at 1187.

<sup>291</sup> Id., Commission's Exhibit No. 106.

<sup>292</sup> Id., at 1202.

<sup>293</sup> Id., Commission's Exhibit 105.

<sup>294</sup> Ibid. The shares to be delivered on each installment payment were 749,867 on December 31, 1937; 196,378 on January 3, 1938; and not in excess of 108,755 on January 12, 1938. The shares to be delivered on January 3 and January 12 were placed in escrow pending payment. (Ibid.)

<sup>295</sup> Id., Commission's Exhibit No. 107. No explanation was offered for the difference of \$300 between this check and the purchase price of the shares.

<sup>296</sup> Mr. Reynolds testified (id., at 1199-1201):

Q. Do you remember when you resigned from the Board after you got your first check or before you got the first check? When did you resign, Mr. Reynolds?

A. Well, it was afterwards. It was all resolved at that meeting; but I think Mr. McConaughy had this check in his hand, our attorney.

Q. This check was dated December 31, 1937. It was not testified until January 3, 1938, and cleared January 4, 1938; but before it cleared or before it was certified, you got off the Board?

A. Yes.

<sup>297</sup> These nominees were Clayton B. Davis, Alexander McLanahan, Franklin E. Mayer, and Sartell Prentice. (Id., Commission's Exhibit No. 94.)



which substantially were the assets of the senior security holders of the company, to new interests who had only partially completed their payment for control. The Reynolds family took no steps to inform the security holders of Reynolds Investing Company, Inc., that they contemplated transferring control of the company and its assets to a new group. C. K. Reynolds testified:<sup>298</sup>

Q. Did you tell Mr. Sartell Prentice or any of his representatives that you would like to apprise the senior stockholders and the minority common stockholders that you were turning over the control to him?

A. Yes.

Q. What did he say?

A. Perfectly agreeable. You see——

Q. I mean before you turned the stock over, did you say you wanted that?

A. No; we did not.

Q. There was no announcement by Reynolds either in the public press or through letters to the securities stockholders that they contemplated selling control?

A. That is right.

Q. At that time when you did sell control, Mr. Reynolds, substantially all of that money of the corporation that could be liquidated belonged to the securities holders—isn't that so—except 4¢ a share?

A. If we had it liquidated at that time.

Q. And I suppose you were perfectly conscious at the time you were turning over to Sartell Prentice control of other people's money; isn't that so?

A. That is right.

Q. Without asking the senior securities holders whether they wanted to be turned over to Sartell Prentice—isn't that so—or without even telling them before you did it that you were going to do it?

A. That is right.

Q. He went to bed one night with the money in the care of Reynolds—and he woke up the next morning and found his money was being managed by Sartell Prentice. They may not have heard of him [Sartell Prentice]. That is right, isn't it?

A. I expect that is correct.

The common stock of Reynolds Investing Company, Inc. had, as has already been indicated, an asset value of only four cents a share and a market value of 81¼ cents a share. Yet C. K. Reynolds testified that the price of \$2 a share paid by Sartell Prentice did not create any suspicion in his mind that it may have been the intention of the buyer to recoup his investment in some manner inimical to the interests of the other security holders of Reynolds Investing Company, Inc., particularly in view of the fact that Sartell Prentice had contracted to pay \$2,110,000 for the Reynolds family's stock interest at a time when the net worth of Prentice & Brady was only \$517,000.<sup>299</sup> Mr. Reynolds testified that he had assumed, because of Mr. Prentice's association with the Rockefeller family, that funds sufficient to meet the contract obligation were assured; that profitable investments could be made by Reynolds Investing Company, Inc., which would redound particularly to the benefit of the common stock of Reynolds Investing Company, Inc. with its "leverage" and thereby

<sup>298</sup> Id., at 1168-9.

<sup>299</sup> Id., at 1187.

give Mr. Prentice a legitimate profit on his common stock holdings; and finally, that Sartell Prentice was interested in Reynolds Investing Company, Inc. as a tax-saving medium. Mr. Reynolds testified.<sup>300</sup>

Q. What would you assume was the reason that Sartell Prentice was paying you a premium of \$1.96 for the common stock?

A. One of the reasons was it is a leverage power. We have seen Reynolds Investing \$1.59 to zero and then it would get back to \$1.29.

Q. The leverage works against you?

A. It works both ways, like a margin account, where you don't have to put up more money. That is the advantage of the leverage power. The other advantage, we had over \$2,000,000 untaken loss, which the company over a period of years made a profit, took its loss and paid no taxes. That is very valuable.

Q. Very valuable to whom?

A. To the company.

Q. Buying losses?

A. Losses are a pretty good thing sometimes.

Q. Did those losses accrue to Mr. Sartell Prentice's benefit.

A. As a man that bought \$2,000,000 worth of stock, it would.

Q. In what respect?

A. Taxes for the company.

Q. Are investment trusts being bought for the reason of buying losses?

A. That is a new one on you?

Q. Yes.

A. That is a valuable thing. You asked me the different reasons that I thought.

Q. We got the leverage and the possibility for income tax purposes.

A. And frankly, the thing that concerned me was whether Mr. Prentice was not in a better position with his connections, relative to the Rockefellers, to know better than I did what we were going to get in the way of inflation.

Q. That I do not understand. His connection with the Rockefellers; what do you mean?

A. He is related to the Rockefellers. That is known in the street all the years that I have been there, and that the firm through the connection received a majority of the business of the Standard Oil Company.

Q. You did not think the Standard Oil Company money was behind Sartell Prentice?

A. I would not say behind him.

Q. You thought he had an inside track that you did not have?

A. I would say that that was possible.

Q. Of course, there were some other ways he could make his money back. That is, after getting control of the securities and the funds of the company, if he wanted to be outrageous about it, he could lay his hands on those assets; isn't that so?

A. But we did not know that in investment trusts that things happened. There were about three or four hundred that changed hands in the last ten years.

Q. You did not think he was more expert than you in the management of a portfolio, did you?

A. I thought any man with his connection, willing to put \$2,000,000 in the company, must have felt very competent in his ability to manage that company for the stockholders.

<sup>300</sup> Id., at 1170-3.

However, although Mr. Reynolds testified that he made these assumptions, he did not ask Mr. Prentice what he "expected to do to get back his two million dollars," which he was to pay for the controlling block of stock.<sup>301</sup>

Notwithstanding these advantages which Mr. Reynolds assumed motivated Mr. Prentice in paying a price of \$2 per share for the common stock of Reynolds Investing Company, Inc., only the common stock of Reynolds Investing Company, Inc. held by the Reynolds family, their friends, and business associates was purchased.<sup>302</sup> C. K. Reynolds testified that he made no effort to have Mr. Prentice make the same offer to minority common stockholders.<sup>303</sup>

Q. Did you say to Mr. Prentice that possibly he ought to buy the stock of the minority stockholders at the same price he was paying you?

A. No; nothing was said about that.

\* \* \* \* \*

Q. But you did make sure, did you not, that all your friend's and family's stock was included in the block that was being sold to Prentice; isn't that so?

A. We were trying to get all the family.

Q. And friends?

A. Well, associates.

\* \* \* \* \*

Q. When you say associate you mean that they were——

A. (Interposing.) With our companies.

Q. Not only with the Reynolds Investing but with other companies?

A. That is right.

Q. Business associates; people who had made investments?

A. That were still with the firm.

Q. But there was not a single share of stock of the public minority stockholders that provision was made for in this list, was there?

A. No.

Q. And you did not ask whether they would make the same offer to minority stockholders?

A. No; we did not.

The Reynolds family turned over to Sartell Prentice and his associates the control and management of approximately \$5,000,000 of the public's liquid assets without ascertaining the investment policies which Mr. Prentice intended to pursue after he obtained control of the company. No provision was made in the contract of sale for a continuance of Reynolds Investing Company, Inc.'s existing policy of investing only in diversified listed securities and in a few "special situations"—a policy which the company had continuously disclosed in its reports to stockholders and upon which these stockholders may have relied. Nor did the contract require the new controlling group to obtain the prior approval of the senior security holders and the minority common stockholders to any contemplated change in the investment policy of the company. In fact, Mr. Reynolds testified that in his opinion he did not owe any obligation to the senior security holders to see that substantially the same type of business would be conducted by the new group:<sup>304</sup>

<sup>301</sup> See *infra*, p. 423.

<sup>302</sup> *Op. cit. supra*, note 1, at 1190-5 and Commission's Exhibit No. 105.

<sup>303</sup> *Id.*, at 1190-1, 1194-5.

<sup>304</sup> *Id.*, at 1196-9.

Q. Coming back to the activities of the Reynolds Investing Company, Inc., the nature of its business all during its entire history was in two big subdivisions—diversified securities and special situations, isn't that so?

A. Yes, of course, in the later years we had more opportunity to dispose of our special situations.

Q. Did you discuss Reynolds Investing Company, Inc., with Sartell Prentice, and tell him what your investment policy had been?

A. No, I did not. He was a very sick man.

Q. Did you discuss it with any associates?

A. Mr. Woodward and Mr. May unquestionably discussed it.

Q. But you did not?

A. No.

Q. Did you ask him what he intended to do to continue the policy of Reynolds Investing Company, Inc., after he got control? What he intended to do with five million dollars of other people's money?

A. I think that was probably generally discussed by Mr. Woodward.

Q. But you did not have any discussion with him?

A. No.

Q. \* \* \* you did not know what he was going to do so far as the investment policy was going to be after he got control?

A. No. I knew he was going to make an investment of two million dollars and that he was going to do the right thing, of course.

Q. From his point of view. But you did not discuss with him how he expected to make back his two million dollars.

A. No; I did not discuss it with him.

Q. Of course, people who were buying your securities may have bought them on reliance that they liked your type of policy, namely, New York Stock Exchange securities and special situation; isn't that so?

A. If we mailed them a statement.

Q. In your report you told them that was your policy?

A. That is right.

Q. And you made no provision in the agreement that Sartell Prentice would continue that policy?

A. No.

Q. And, of course, the only thing was that you thought he would do the right thing because he had two million dollars in there?

A. Yes; and his reputation.

Q. However, it was possible for him, when you turned over control of the board, to go into an entirely different type of policy than the Reynolds family pursued; isn't that so?

A. He could do it. Of course, in doing so, he must have thought he was acting for the best interests of the stockholders.

Q. I understand. Didn't you have any difficulty with this situation, that I, who am putting my money in an investment trust ought to have something to say, at least as to what the nature of the business of that investment trust is going to be?

A. If you put it in as a minority stockholder, you would not expect that, would you?

Q. Suppose I put it in in the form of senior money?

A. I think you would still be in the same category. You would have no vote at all.

Q. Probably that would put a greater obligation on the people who were controlling the company because they had the vote; but here they had an invest-

ment that was running along certain lines, and you say nobody owed them any obligation to see that substantially the same type of business was being conducted before they were told that the business was being changed. You did not feel that any such obligation was due to the stockholders?

A. I do not feel that way.

\* \* \* \* \*

Q. But you got nothing in the writing from Mr. Prentice as to what he was going to do with the \$5,000,000. How he was going to invest it?

A. No.

Q. As a matter of fact, you did not discuss it with him although Mr. Woodward may have discussed it with him?

A. No; that is right.

Finally, although C. K. Reynolds testified that the Reynolds family stood in a fiduciary relationship to all of the security holders of Reynolds Investing Company, Inc., the Reynolds family did not insist on retaining any representation on the new board of directors of Reynolds Investing Company, Inc., in order to observe, for the protection of the holder of senior securities and the minority common stockholders, the methods of operation of the company by the new group. In fact, as has already been indicated, all of the old directors resigned and elected the representatives of Mr. Prentice in their stead, at a time when Mr. Prentice had only made his initial payment on his contract of purchase and had received only a minority block of the company's common stock. Mr. Reynolds testified that the old directors resigned as a "natural thing" after the receipt of the initial contractual payment from Mr. Prentice:<sup>305</sup>

Q. When you saw the statement "In effecting transfer of this commitment, I assume that the entire board of directors will resign, together with the officers," did you discuss that with Mr. Woodward?

A. No; I didn't discuss that with Mr. Woodward. There was no agreement, no definite understanding that we would get off the board as far as that is concerned.

\* \* \* \* \*

Q. Did you talk to him about cleaning out the old board?

A. Not a word was mentioned about it.

Q. Ultimately the whole board got off?

A. That is right.

Q. When was there any discussion about the whole board getting off?

A. There was no discussion with him. It was just a natural thing after we had sold our stock that we would get off the board.

Q. Of course, the new board could not be elected until the next annual meeting. When was that supposed to take place?

A. That would be in March.

Q. And you say there was no discussion as to the entire board resigning and doing it through the mechanics of one director resigning and a new one being elected?

A. There was certainly no understanding or discussion with me at all, all along the line. It was just a natural course that took place.

Q. Did you say to Mr. Prentice: "There are the senior securities holders to whom we sold securities—we are the directors; our name is in the company

<sup>305</sup> Id., at 1166-7.

name; we feel that we ought to have somebody on the board of directors to see what transpires and what happens to the company"; was there any discussion on that?

A. No; there was not.

Q. You did not ask for anybody on the board?

A. No.

Although the contract for the purchase of control of Reynolds Investing Company, Inc., was made with Mr. Mayer, who was acting ostensibly for Sartell Prentice, Sartell Prentice was not purchasing nor did he ever intend to purchase for his own account this controlling block of stock of Reynolds Investing Company, Inc. Sartell Prentice and the other members of the Fiscal Management group were causing Continental Securities Corporation which they now controlled to acquire control of Reynolds Investing Company, Inc. The major portion of the funds for the payments on the contract of purchase ostensibly made by Sartell Prentice ultimately came from Continental Securities Corporation, yet the public announcement in the first instance was to the effect that Sartell Prentice had acquired control of Reynolds Investing Company, Inc., thereby withholding from the security holders of the Continental Securities Corporation the fact that their funds were employed in that venture.<sup>306</sup>

It will be recalled that at the closing of the contract for the purchase of control of Reynolds Investing Company, Inc., a down payment of \$1,499,434 was made against delivery of 749,867 shares of the common stock of Reynolds Investing Company, Inc. This payment was made by a check drawn by Prentice and Brady. One-half hour after this first payment,<sup>307</sup> Mr. Mayer, at the request of Mr. Ferretti, assigned to Continental Securities Corporation the contract to purchase the control block of stock of the Reynolds Investing Company, Inc. Mr. Mayer testified:<sup>308</sup>

Q. When you say you never heard the name Continental Securities Corporation, up to what time is that?

A. To about seven o'clock that evening.

Q. And where did you hear it?

A. I was going out of the door with my hat and coat on and I had the contract in my—or I didn't have it, Mr. Stevens had the contract, and it was in my name and I was going on about my business with that contract and Mr. Ferretti called me back and told me that the contract covering the control of the Reynolds Investing Company, Inc., could not remain in my name over the year end.

Q. Did you ask him why?

A. Yes, sir.

Q. And what did he say?

A. Something may happen to me. And I said, "All right, how about my commission check?" He said, "We can't give you your commission, we have no more checks here, and after all, Prentice & Brady are handling the deal for the

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<sup>306</sup> On January 13, 1938, announcement was made that Sartell Prentice, a partner of Prentice & Brady, and F. E. Mayer had taken over a majority common-stock interest in and management of Reynolds Investing Co., Inc. (Standard Corporation Records, Daily News Section, January 13, 1938, at 9839.)

<sup>307</sup> Op. cit. supra, note 1, at 1331.

<sup>308</sup> Id., at 1329-31.

buyers and we can't expect them to pay you your commission." so there was nothing for me to do. I couldn't carry this two-million-dollar contract away in my name so Mr. Stevens suggested I should assign the contract.

Q. To whom?

A. I started to assign it at his dictation to Sartell Prentice and Ferretti interrupted and said, "Mr. Prentice is sick and just came out of the hospital." \* \* \* And he said, "You can't assign it to Mr. Prentice. The man may die. He has a streptococci infection." So they decided to assign it to Continental Securities Corporation. I said, "Why Continental Securities?" Mr. Stevens said, "Undoubtedly Mr. Ferretti has arranged to lodge the contract temporarily until they can straighten this thing out the first of the year."

Q. The check was a Prentice & Brady check?

A. Yes.

Q. And did you go to the movies to find out who Continental Securities Corporation was?

A. I did nothing.

Q. You did nothing?

A. No, sir.

Q. Did you do it the next day?

A. No; and an unfortunate happening took me away from home the next day.

Q. So a half hour after the contract was taken to Prentice's name or in your name, rather, you were asked to execute an assignment to Continental Securities Corporation about which you had never heard before?

A. I never heard about Continental Securities.

Q. You didn't know whether it was a public company or a private company, is that it?

A. Well, it seemed all right to Mr. Brady and after all he had paid out some pretty good money for it.

At this time Continental Securities Corporation had a cash credit balance of \$1,106,175.77 in its account with Prentice & Brady<sup>309</sup>—the account which had been opened with that firm immediately after the Fiscal Management group had taken control of Continental Securities Corporation and to which account Paine, Webber & Co. had transferred the balance of the portfolio securities of Continental Securities Corporation. In addition, Continental Securities Corporation had in that account with Prentice & Brady securities of a value of \$93,250.63. The cash in the account was the proceeds of the continuous liquidation, commencing about December 20, 1937, of the marketable securities in the account on the advice of Prentice & Brady.<sup>310</sup>

However, this \$1,106,175.77 cash balance of Continental Securities Corporation with Prentice & Brady was insufficient to meet the first payment required by the contract for the purchase of the control block of stock of Reynolds Investing Company, Inc.<sup>311</sup> In order to procure these required additional funds, the firm of Prentice & Brady borrowed \$260,000 from the New York Stock Clearing Corporation and New York Curb Clearing Corporation and an additional \$200,000 from National City Bank. The bank loans were secured by the unauthorized hypothecation by Prentice & Brady<sup>312</sup> of securities in the brokerage accounts maintained with that firm by members of the

<sup>309</sup> Id., Commission's Exhibit No. 109.

<sup>310</sup> Id., at 1218-9.

<sup>311</sup> Id., at 1213, 1219, and Commission's Exhibit No. 109.

<sup>312</sup> Id., at 1220; 1222-3; 1286-7; and Commission's Exhibit No. 115.

family of Irwin Hiltz, a partner in Prentice & Brady.<sup>313</sup> These loans, totaling \$460,000, were charged to the account of Continental Securities Corporation with Prentice & Brady. Mr. Iffland, cashier of Prentice & Brady testified:<sup>314</sup>

Q. Prior to the time that occurred,<sup>315</sup> had you received any instruction from Mr. Brady or Mr. Prentice with respect to the bank balances?

A. Yes. They told me to build them up as much as possible.

Q. What does that mean, in layman's language?

A. That he wanted me to carry as large a bank balance as possible.

Q. And how did you create that bank balance?

A. By making stock loans.

Q. That is, you took your customers' securities, made loans on them, and built up the bank balances in that way, is that it?

A. That is right.

Q. When had you received those instructions from him?

A. I don't know. I think it was around some time in December.

Q. Who was the one who gave you those instructions, Prentice or Brady?

A. Mr. Brady.

Q. And did you commence building up the bank balance?

A. Yes.

\* \* \* \* \*

Q. Now in order to build up that bank balance had you established a credit with the Curb Clearing Corporation and the New York Stock Exchange Clearing Corporation for a couple hundred thousand dollars?

A. Yes.

Q. That was \$200,000, and you put that in the bank?

A. That is right.

Mr. Iffland further testified:<sup>316</sup>

Q. You still were short some money to make that \$1,499,000 payment on December 31st for which you drew the check in that amount?

A. Yes.

Q. That is where Hiltz securities came in, isn't that so?

A. Yes.

Q. You were telling us the status of the Hiltz accounts, showing us some had credit balance and some had debit balances. But the fact of the matter was that the securities had been segregated in some of those accounts, isn't that so? They kept enough securities in the account to margin it in accordance with Regulation T.<sup>317</sup> did they not?

A. Yes.

<sup>313</sup> In April 1938 the Committee on Business Conduct of the New York Stock Exchange expelled the partners of the firm of Prentice & Brady from membership in the exchange. They were charged with having made improper use of securities belonging to certain customers of their firm. (*The New York Times*, April 27, 1938.) The Attorney General of New York obtained an injunction prohibiting the members of the firm of Prentice & Brady from participating in the lending of funds on collateral of portfolio securities or in negotiations or purchase or sale of any portfolio securities held by any investment trust unless permission were granted by every stockholder or bondholder in the trust. (*Id.*, May 28, 1938, p. 1.) The firm of Prentice & Brady was dissolved on March 25, 1938. (*Id.*, March 25, 1938, p. 27.)

<sup>314</sup> *Op. cit. supra*, note 1, at 1211, 1220.

<sup>315</sup> That is, prior to December 31, 1937, the date of the closing of the contract for the purchase of control of Reynolds Investing Company, Inc.

<sup>316</sup> *Op. cit. supra*, note 1, at 1220-3.

<sup>317</sup> Regulation T refers to the rules and regulations relating to margin requirements formulated, pursuant to Section 7 of the Securities Exchange Act of 1934, by the Federal Reserve Board.



Q. And the balance of the securities were put into a vault or box for safekeeping; isn't that so?

A. Yes.

Q. Those securities which were put into the vault or box for safekeeping Prentice & Brady hadn't any lien against them, isn't that so?

A. Yes.

Q. By "yes" you mean they had no lien?

A. I mean there is a debit in the account. I think they had a lien.

Q. There was a debit in the account; but why did you segregate them out and put them in the box if it was not for the fact that the securities that you had in the account and that you did not segregate were sufficient to satisfy the margin requirements, why did you segregate some of the securities?

A. That was our practice down there.

Q. Now there is no doubt if the Hiltz family came and said "give us the securities that you got in the box and that you segregated out," they would get them back?

A. Yes.

Q. And those were the securities in the account, isn't that true?

A. Yes.

Q. Now those are the securities that you took and went to the bank and made a loan on, isn't that so?

A. Yes.

Q. By "those" I mean the securities that had been selected out and put in the box for safekeeping for the Hiltz account, isn't that so?

A. Yes.

Q. Who told you to do that?

A. Mr. Brady.

Q. Did Mr. Prentice tell you to do that too?

A. No.

Q. Did you discuss it with him?

A. No.

Q. What did Mr. Brady say to you with respect to these securities?

A. He just told me to use the Hiltz family securities and borrow money on it.

Q. Did you say to him, "Mr. Brady, these securities you know have been segregated out and there are sufficient securities in the margin account to adequately margin that account. Have you authority to hypothecate these securities?"

A. I didn't question him.

Q. You didn't question him? Now you got those securities and you hypothecated them for how large a loan, do you remember?

A. Well, offhand, I don't know the amount.

Q. \$200,000 at the National City Bank, does that sound familiar to you?

A. Yes.

Q. That is so, isn't it?

A. Yes.

Q. So you had the \$260,000 that you got through the Stock Clearing Corporation and you had \$200,000 that you borrowed on the securities which were being kept for safekeeping for the Hiltz family and that gave you \$460,000, which was the amount needed to make up the \$1,499,000 check, isn't that so?

A. Yes.

On January 3, 1938, another payment of \$392,756 was due by Continental Securities Corporation to take up an additional 196,378 shares

of common stock of Reynolds Investing Company, Inc.<sup>318</sup> At this time, Continental Securities Corporation was indebted to Prentice & Brady in the sum of \$400,000, which Prentice & Brady had advanced in order to enable Continental Securities Corporation to make the first payment of \$1,499,434 on the contract of purchase of Reynolds Investing Company, Inc., stock. It will be recalled that this \$400,000 had been raised in part by Prentice & Brady through the unauthorized hypothecation of the securities of the members of the Hiltz family with the National City Bank.<sup>319</sup> It was incumbent, therefore, upon Continental Securities Corporation to raise additional cash in order to meet its contract commitment and to pay off the loan from Prentice & Brady which then would be in a position to pay off its bank loans and thereby become repossessed of the Hiltz securities. Prentice & Brady and the others in the Fiscal Management group thereupon proceeded to use the assets of Reynolds Investing Company, Inc., which had come under their control on December 31, 1937, to raise the cash to enable Continental Securities Corporation to meet these obligations.

On January 3, 1938, the members of the group, without any prior resolution of even the new board of directors of the Reynolds Investing Company, Inc., authorizing such action, removed from the vault of that investment company part of its portfolio securities with a market value of approximately \$882,500.<sup>320</sup> On the same day, January 3, 1938, Prentice & Brady then used these portfolio securities of the Reynolds Investing Company, Inc. taken from the vault, as collateral for loans in the aggregate amount of \$450,000 from the Public National Bank and Trust Company, Commercial Bank and Trust Company, and the National City Bank of New York.<sup>321</sup> Mr. Iffland, when examined on the authority of Prentice & Brady to hypothecate these securities for these loans, testified as follows:<sup>322</sup>

<sup>318</sup> Op. cit. supra, note 1, Commission's Exhibit No. 105.

<sup>319</sup> See supra, pp. 426-7.

<sup>320</sup> Messrs. Clayton, Ferretti, McLanahan, Mayer, and Stevens accompanied Mr. Iffland, Prentice & Brady's cashier, to the Reynolds Investing Company, Inc., vault in Jersey City. Mr. Iffland claimed that he did not see either Mr. Prentice or Mr. Brady there. (Op. cit. supra, note 1, at 1231-4.) However, the access card to the Reynolds Investing Company, Inc., vault indicates that Mr. Prentice signed the authorization for the opening of the vault. Mr. Iffland claimed that he received the securities from Mr. Clayton Davis, checked them against a list which he had received from Mr. Clayton, and brought them to New York to the office of Prentice & Brady. (Id., at 1231, 1235.) Mr. Iffland testified as follows (id., at 1235):

Q. \* \* \* somebody you say took the securities out of the box and brought them to you. Who handed these securities to you; do you remember?

A. I think it was Mr. Davis.

Q. Clayton Davis?

A. Yes.

Q. And what did you do with them?

A. We checked them against the list and brought them back.

Q. And?

A. And brought them back to New York.

Q. In bags?

\* \* \* \* \*

A. No; we wrapped them up in a paper.

Q. Just wrapped up about twenty-five percent of that trust in a newspaper, was it, and brought it back to New York?

A. No; regular wrapping paper.

Q. Regular wrapping paper. Then what did you do with them?

A. We brought them back to New York and proceeded to make the entries of receiving the securities into the account.

<sup>321</sup> Id., at 1230, 1231-8. A "day loan" of \$100,000 from National City Bank was made. (Id., at 1237.)

<sup>322</sup> Id., at 1230-1.

Q. Did you at any time see a resolution in the Reynolds Investing Company authorizing the sale of these securities or permitting Prentice & Brady to hypothecate them for any loan?

A. No.

Q. Now Reynolds Investing was not making this loan, were they? The securities that you saw, the list?

A. Yes.

Q. That wasn't for a loan for Reynolds Investing Company, was it?

A. No; that was various stocks.

Q. And that was going to be used for a loan for Mr. Sartell Prentice, ultimately for Continental Securities Corporation, who needed that money and who ultimately made a loan on it?

A. Yes.

Q. Reynolds Investing Company wasn't making that loan, was it?

A. No.

Q. Who was making that loan?

A. That was just made to build up the bank balances.

Q. Of Prentice & Brady?

A. Of Prentice & Brady.

Q. So that they could make the check for \$392,000 which they needed that day; isn't that so?

A. That is right.

Q. So the loan was being made on Reynolds Investing Company securities for Prentice & Brady's account; isn't that so?

A. That is right.

With these borrowings Prentice & Brady then had sufficient funds to meet the second payment due on the contract to purchase Reynolds Investing Company, Inc. common stock and to pay off the prior bank loans which were secured with the securities of the members of the Hiltz family.<sup>323</sup> These additional loans in the sum of \$450,000 were then charged against the account of the Continental Securities Corporation with Prentice & Brady, thereby increasing the debit balance of that investment company in that account to approximately \$900,000.<sup>324</sup>

Thus, portfolio securities of Reynolds Investing Company, Inc., with a market value of approximately \$882,500, were removed from the vault of Reynolds Investing Company, Inc., and were hypothecated for loans which were used in part to meet Continental Securities Corporation's second installment payment on the purchase contract of the controlling block of stock of Reynolds Investing Company, Inc., and to repay the loans made on behalf of Continental Securities Corporation in connection with the first installment on the contract. Furthermore, as has already been indicated, Continental Securities Corporation was at this time indebted to Prentice & Brady in the amount of \$900,000. It was therefore incumbent upon the group at this stage to (1) "reimburse" Reynolds Investing Company, Inc., for the portfolio securities valued at approximately \$882,500 which had been re-

<sup>323</sup> Id., at 1237.

<sup>324</sup> Id., Commission's Exhibit No. 108. The amount of the check which was drawn by Prentice & Brady to meet the second payment on the Reynolds Investing Company, Inc., common stock was subsequently debited to the account of Continental Securities Corporation with Prentice & Brady which at this time was approximately \$900,000. (Id., at 1239-45.)

moved from the vault of the investment company, and (2) provide Continental Securities Corporation with sufficient cash to repay the advances made on its behalf by Prentice & Brady.

Accordingly, on the following day, January 4, 1938, Reynolds Investing Company, Inc. was caused to accept the offer of the Continental Securities Corporation (which the group already controlled) to sell Continental Securities Corporation's block of 8,825 shares preferred stock of Fiscal Management Company, Ltd., for \$882,500 to Reynolds Investing Company, Inc. (which the group also controlled).<sup>325</sup> The effect of this transaction was to replace the marketable portfolio securities, valued at \$882,500, which had been removed from the vault of Reynolds Investing Company, Inc. with 8,825 shares of the preferred stock of Fiscal Management Company, Ltd., valued for purposes of the transfer at \$882,500, and to supply Reynolds Investing Company, Inc. with sufficient cash to pay Continental Securities Corporation for the 8,825 shares of preferred stock of Fiscal Management Company, Ltd. Further, as a result of this transaction, Continental Securities Corporation was supplied with the cash to meet the major portion of its debit balance in its account with Prentice & Brady.

In order to raise the \$882,500 necessary to take up the block of preferred stock of Fiscal Management Company, Ltd., from Continental Securities Corporation, Prentice & Brady, on January 6, 7, 10, and 11, sold the portfolio securities of the Reynolds Investing Company, Inc. which had been removed from the vault on January 3, 1938,<sup>326</sup> part of which securities had been hypothecated by Prentice & Brady with banks as collateral on loans. The proceeds of the sale of these portfolio securities were credited to the account of the Reynolds Investing Company, Inc.<sup>327</sup> Prentice & Brady then issued its check in the sum of \$882,500 to the Reynolds Investing Company, Inc.<sup>328</sup> The officers of the Reynolds Investing Company, Inc., endorsed this check over to Continental Securities Corporation in payment for the 8,825 shares of preferred stock of Fiscal Management Company, Ltd. which were sold to Reynolds Investing Company,

<sup>325</sup> Id., Commission's Exhibit No. 94. It will be recalled that the Fiscal Management Company, Ltd., was the company which was controlled by the group and which owned only controlling blocks of stock of First Income Trading Corporation and of Continental Securities Corporation. It will also be recalled that 7,000 of these preferred shares were placed by the group in the portfolio of Continental Securities Corporation "to reimburse" that corporation for its portfolio securities which had been liquidated to raise the cash needed by the group to purchase the control of Continental Securities Corporation from the J. Henry Schroder interests. The remaining 1,825 shares of preferred stock of Fiscal Management Company, Ltd. had been sold to Continental Securities Corporation by First Income Trading Corporation, also controlled by the group. First Income Trading Corporation, as has been indicated, had acquired its block of preferred stock of Fiscal Management Company, Ltd. in a manner similar to that of Continental Securities Corporation, "to reimburse" First Income Trading Corporation for its portfolio securities which had been sold to raise the cash needed by the group to purchase control of First Income Trading Corporation from Messrs. Grow and Wicks and their associates.

<sup>326</sup> Id., Commission's Exhibit 94.

<sup>327</sup> Id., Commission's Exhibit No. 112. The signature cards and papers authorizing the receipt and sale of securities in that account, were not signed by the officers of Reynolds Investment Company, Inc., until January 10 and 13, 1938. (Id., at 1239, 1352-6 and Commission's Exhibits Nos. 122, 123, 125.)

<sup>328</sup> Id., at 1240 and Commission's Exhibit No. 113.

Inc.<sup>329</sup> The officers of Continental Securities Corporation in turn endorsed this check to Prentice & Brady in part settlement of the debit balance of approximately \$900,000 in the account of that investment company with Prentice & Brady—a debit balance which was created by loans which Prentice & Brady made on behalf of Continental Securities Corporation in order to enable that investment company to purchase the controlling block of Reynolds Investing Company, Inc., common stock.<sup>330</sup> This check for \$882,500 never was deposited in or cleared through any bank. Mr. Iffland, the cashier of Prentice & Brady, testified that the check with its various endorsements had the effect, first, of giving a “credit balance in favor of Reynolds Investing Company, Inc.,” then giving a “credit balance in favor of Continental Securities Corporation,” and finally wiping out in part the “debit balance against Continental Securities Corporation.” When examined as to the migrations of this check which never “touched a bank,” Mr. Iffland testified as follows:<sup>331</sup>

Q. Weren't you rather surprised to see this check with the endorsement of Reynolds Investing Company and then to Prentice & Brady and then endorsed by Prentice & Brady [to] Continental Securities Corporation, and then back again? Did you speak to anybody about that?

A. No; I did not.

Q. Can you tell me another case in your entire association with Prentice & Brady or any stock exchange firm where a check for \$882,000 or any amount was ever drawn that made the rounds of endorsements and never cleared any bank?

A. No.

Q. Didn't that look suspicious to you? Didn't you ask them how it is this thing never cleared any bank? Did you speak to Mr. Prentice and ask him what is this all about?

A. No; I didn't.

Q. You didn't speak to anybody at all?

A. No.

Q. You never have seen a transaction like that before in your life, before this one, did you?

A. No.

Q. Now, after you drew this check it was endorsed “pay to the order of Continental Securities Corporation.” Then of course you credited the account of Continental Securities Corporation in the amount of this check, isn't that so?

A. That is right.

\* \* \* \* \*

Q. That washed out Continental Securities Corporation's debit balance, practically, except the difference between the \$900,000 and the \$882,000.

A. Yes; \$40,000.

Q. And then this check was endorsed to Prentice & Brady and the account of Reynolds Investing was debited with \$882,000 which wiped out its credit balance; isn't that so?

A. Yes.

<sup>329</sup> Id., at 1245.

<sup>330</sup> Id., at 1245 and Commission's Exhibits Nos. 109, 113.

<sup>331</sup> Id., at 1243-7.

Q. Just a "ring-around-the-rosy" to wash out the credit balance in favor of Continental, and the debit balance against Continental and the credit balance in favor of Reynolds Investing, isn't that what it was?

A. Yes; yes, it was charged to the Reynolds Investing and credited to the Continental.

\* \* \* \* \*

Q. \* \* \* you sat down and drew a check for \$882,500 because you were instructed to do so and it was endorsed over to Continental Securities Corporation, and Continental Securities Corporation then endorsed it over to Prentice & Brady, and then Prentice & Brady endorsed it over to Continental Securities Corporation; isn't that so?

The first endorsement is "Pay to the order of Continental Securities Corporation." Then you have got "Reynolds Investing Company, Inc.," by two of its officers, Galvin and Mayer, and then it says "Pay to the order of Prentice & Brady," and then "Continental Securities Corporation by Johnson and Bahntge." So that the check first went to Continental Securities Corporation and then went to Reynolds Investing Company, and from Reynolds Investing Company it went to Continental, from Continental it went back to Prentice & Brady.

A. To Prentice & Brady.

Q. And never touched the bank, isn't that so?

A. That is it.

The minute of the board of directors authorizing Reynolds Investing Company, Inc., to purchase the 8,825 shares of preferred stock of Fiscal Management Company, Ltd., from the Continental Securities Company for \$882,500 was dated December 31, 1937, the very day that the group obtained control of the Reynolds Investing Company, Inc.<sup>332</sup> This minute, however, was unsigned. Franklin E. Mayer, secretary of Reynolds Investing Company, Inc., under the new management, denied that the purchase of this block of Fiscal Management Company, Ltd. preferred stock was ever discussed or mentioned in the minutes of the meeting of December 31, 1937.<sup>333</sup> Mr. Mayer described these minutes as "a tire patch—something they thought of afterwards."<sup>334</sup> On January 10, 1938, when Mr. Mayer returned from a trip, he was requested by the members of the group to sign a minute of the board of directors of Reynolds Investing Company, Inc., dated January 4, 1938, ratifying the purchase of the \$882,500 of preferred stock of Fiscal Management Company, Ltd. Mr. Mayer testified that he protested both against the purchase and its ratification:<sup>335</sup>

A. I told him that I thought the new group had taken unfair advantage of the Board of Directors, that the deal in the Fiscal Management stock was not an approved investment because it was approximately one-sixth or thereabouts of the assets of the trust and that was too much to go into one situation. Mr. Ferretti said the Board was agreeable, that I was apparently the only one that was not agreeable. I told him if it had been more like \$200,000 I might be agreeable, but that this transaction was not a prudent transaction and I could not see my way clear to agree with him.

\* \* \* \* \*

<sup>332</sup> Id., Commission's Exhibit No. 94.

<sup>333</sup> Id., at 1327-9.

<sup>334</sup> Id., at 1328, 1351-2.

<sup>335</sup> Id., at 1354-5, 1357.

I told Mr. Ferretti that I could not confirm the sale of securities, that I had nothing to do with it. I told him, furthermore, that the securities had been sold to raise \$882,000 which had been put into the South American deal, as far as I know.

Q. \$882,000?

A. Yes. In the stock of Fiscal Management, which indirectly meant the South American Utility deal. I asked him to put the entire South American Utility deal, the securities, the bonds, or notes, whatever they had, into the vaults of the Reynolds Investing Company in Jersey City. He said he could not do that very well, that his clients could not do that very well—they had the bulk of the funds in this deal—so I told him that I could not accept the responsibility for the absence of that volume of public funds in the shape it was in at the present time, that is, having Fiscal stock. So I took it that when I consented to sign the confirmations that we would be given the entire South American deal to be put in the vaults of the Reynolds Investing Company. It might take a day or two to do it, but it was understood that the securities were to be put there, and while we would not attempt to control the reorganization, we would have a large part to say in it.

Thus, the effect of this transaction was to have liquid portfolio securities of Reynolds Investing Company, Inc., valued at \$882,500 liquidated and the proceeds used to pay the Reynolds family for a portion of the control block of stock of Reynolds Investing Company, Inc., acquired by Continental Securities Corporation. Mr. Reynolds testified in this connection as follows:<sup>336</sup>

Q. I am looking back now in the light of what we know today, or what you understand today. Don't you understand today that \$882,000 of the \$2,200,000 that you got came out of Reynolds Investing?

A. Yes; I understand that.

\* \* \* \* \*

Q. You wouldn't even remotely dream of having the investment trust, the Reynolds Investing Company, buy your stock back at \$2 a share, at the time you sold to Sartell Prentice, would you?

A. Well, of course, we would not sell any stock to the company.

Q. You would not even dream of selling your own stock back to the Reynolds Investing Company, would you?

A. We certainly would not sell our stock to the company.

Q. And particularly you would not sell it back at \$2 a share when the asset value was 4 cents, isn't that so?

A. We just would not sell it to the company, that is the answer to that.

Q. Why not?

A. Why not? I think we would be selling it to ourselves.

Q. You would be on both sides of the table, is that right?

A. That is right.

Q. But you know now that that was what transpired. That the Reynolds Investing Company bought your stock back at \$2 a share.

A. Well, that is the understanding.

\* \* \* \* \*

Q. (Interrupting.) You would not have countenanced it if Sartell Prentice said to you, "Mr. Reynolds, we are going to pay you two-million-odd thousand dollars for your stock and we are going to raise \$882,000 of that by selling

<sup>336</sup> Id., at 1158-63.

immediately portfolio securities of the Reynolds Investing Company." Would you have done business with them?

A. Certainly not.

Q. Why not?

A. It just would not be right.

Q. You would have the situation where he was virtually buying control of the investment trust with the investment trust's own money. Is that right?

A. Right.

Q. And then putting in stock at least of a dubious value in that portfolio?

A. That is right.

Q. Yet the fact is, Mr. Reynolds, that you understand today that that is the way he did it, is that so?

A. That is correct.

Q. \* \* \* How would you characterize a deal like that, when they paid you \$2,200,000 and then immediately the same day, sold the investment trust \$882,000 of the stock of the Fiscal Management Company which had nothing except First Income Trading and the Continental Securities? Did you conceive that that was an honest deal with the Reynolds Investing Company?

A. Certainly, nothing that I would have done.

Q. And yet you can see what the present situation is, that the \$882,000 is today in the possession of the Reynolds family by virtue of something done by Sartell Prentice, which you would not have done. Isn't that so?

A. That is correct.

However, Reynolds Investing Company, Inc., as a result of this transaction, held in place of diversified marketable securities with a market value of \$882,500, a block of 8,825 shares of the preferred stock of Fiscal Management Company, Ltd. This preferred stock had no market and represented an interest in a company which held only a controlling block of management stock of First Income Trading Corporation, which had no market and a liquidating value of only \$5,000, and a controlling block of the common stock, which had no asset value, of Continental Securities Corporation, which in turn held the controlling block of common stock of Reynolds Investing Company, Inc., itself, which, as a result of this transaction, had no asset value.<sup>337</sup> Subsequently, on January 12, 1938, First Income Trading Corporation, still controlled by the group, supplied approximately \$217,000 needed to take up the third and last block of 108,565 shares of the common stock of Reynolds Investing Company, Inc.<sup>338</sup>

To recapitulate, of the funds required to meet the commitment on the Reynolds contract, made in the name of Franklin E. Mayer, but ostensibly on behalf of Sartell Prentice, approximately \$1,000,000 came from Continental Securities Corporation, \$882,500 from Reynolds Investing Company, Inc., itself, and \$217,000 from First Income Trading Corporation. The Fiscal Management group therefore acquired control of Reynolds Investing Company, Inc. without having "put a nickel" into the entire transaction.<sup>339</sup>

Not only did the members of the group not invest any of their funds in this venture, but they took substantial sums as "commis-

<sup>337</sup> As a result of this transaction, Fiscal Management Company, Ltd. controlled Continental Securities Corporation, which in turn controlled Reynolds Investing Company, Inc., which in turn held the outstanding preferred stock of Fiscal Management Company, Ltd., thereby creating a system of circular ownership.

<sup>338</sup> Op. cit. supra, note 1, Commission's Exhibit No. 75.

<sup>339</sup> Id., at 1366.



sions" in connection with this transaction. Prentice & Brady took \$52,000 from Continental Securities Corporation as "commissions" alone on this deal.<sup>340</sup> Mr. Mayer received \$40,000, which was divided as follows: \$5,000 to Mr. Clayton or Mr. Callanan;<sup>341</sup> \$8,500 to Mr. Davis; \$2,750 to Mr. Henroten; \$2,750 to Mr. Rowe; \$3,000 to Mr. Feurst; \$8,500 to Mr. Conroy; and \$8,500 to Mr. Mayer.<sup>342</sup> The check for \$40,000 which Mayer received was drawn on Calmur & Company, Inc. (the dummy corporation of the group), by Mr. Ferretti but the funds came from Continental Securities Corporation.

Immediately upon the completion of the acquisition of the control of Reynolds Investing Company, Inc., Messrs. Beverly, Ferretti (characterized as the "message sender" in this transaction<sup>343</sup>), and Clayton, "without much ceremony"<sup>344</sup> insisted that the new officers and directors of Reynolds Investing Company, Inc. supply \$2,000,000 "to lift the deal from the Chase Bank"<sup>345</sup>—Mr. Beverly's commitment to purchase the South American Utilities Corporation collateral notes. Mr. Mayer testified that when the Fiscal Management group asked him "to liquidate sufficient portfolio securities of Reynolds Investing Company, Inc., to raise the \$2,000,000, he took refuge behind the 110 percent clause to give [him] a chance to collect [his] thoughts."<sup>346</sup> However, Mr. Mayer and other officers did request Manufacturers Trust Company to advance to Reynolds Investing Company, Inc. \$2,000,000 in order that the investment in South American Utilities Corporation notes could be effected.<sup>347</sup> As has already been indicated, the Manufacturers Trust Company refused to make the loan.<sup>348</sup>

Messrs. Mayer and McLanahan then approached the Chase National Bank for the loan, which, as has been indicated, was likewise refused on the ground that the Chase National Bank was trustee for the debentures of Reynolds Investing Company, Inc.<sup>349</sup>

The Fiscal Management group continued to exert pressure on Mr. Mayer and the other directors of the Reynolds Investing Company, Inc., to make available the balance of \$2,000,000 still due on the contract to purchase the South American Utilities Corporation collateral notes from the Chase National Bank and associates. Mr. Mayer and one other director of Reynolds Investing Company, Inc. then considered it advisable to consult an attorney with respect to the entire situation.<sup>350</sup> Accordingly, on February 11, 1938, approximately one month after the Fiscal Management group had acquired control of

<sup>340</sup> Id., at 593.

<sup>341</sup> Cf. testimony of Mr. Mayer, id., at 1355. Mr. Mayer indicated that Mr. Ferretti had asked him to give \$5,000 to Callanan, since Ferretti "had had to use Mr. Callanan extensively."

<sup>342</sup> Id., at 1380-1.

<sup>343</sup> Id., at 970.

<sup>344</sup> Id., at 1359.

<sup>345</sup> Id., at 1359-61.

<sup>346</sup> Id., at 1361. The 110-percent clause refers to the provision in the debenture which provided that if the assets of the company were not in excess of 110 per cent of the amount of the debentures outstanding, then the debentures were in default, and the debenture holders could take steps to liquidate the company.

<sup>347</sup> Id., at 1372-3.

<sup>348</sup> Id., Commission's Exhibit No. 127. This transaction has been described in detail under the discussion of the acquisition by the Fiscal Management group of control of Continental Securities Corporation.

<sup>349</sup> Id., at 527-8, 531, 1373, 1375-6.

<sup>350</sup> Id., at 1368.

Reynolds Investing Company, Inc., Mr. Mayer and his associates invited Mr. Chadbourne, of the law firm of Chadbourne, Hunt, Jaeckel & Brown, to act as the attorney for Reynolds Investing Company, Inc.<sup>351</sup>

As the result of the resistance of Mr. Mayer and Mr. Chadbourne to the activities of the group, the remaining assets of Reynolds Investing Company, Inc. were not used by the Fiscal Management group.

In May 1938 involuntary proceedings were instituted for the reorganization of Reynolds Investing Company, Inc.<sup>352</sup>

## **C. Activities of Northern Fiscal Group in the Acquisition of Control of Insuranshares Corporation of Delaware, Bond and Share Trading Corporation, and Burco, Inc.**

### **1. INTRODUCTION**

Almost contemporaneously with the activities of the Fiscal Management group in connection with the acquisition of control of First Income Trading Corporation, Continental Securities Corporation, Corporate Administration, Inc., and Reynolds Investing Company, Inc., S. Leo Solomont, Ralph A. Robb, and Thomas W. Morris, all of whom had been associated with some aspect of the program of the Fiscal Management group,<sup>353</sup> commenced an independent program to acquire control of other investment companies by methods similar to those that had been employed by the group.

Mr. Solomont and his associates caused to be organized under the laws of the Dominion of Canada a personal holding company, known as Northern Fiscal Corporation, Ltd. This corporation was to be utilized in a manner similar to that of Fiscal Management Company, Ltd.

Between December 1937 and March 1938, a period of approximately four months, Messrs. Robb, Morris, and Solomont, and their associates, hereinafter referred to as the Northern Fiscal group, acquired control of three investment companies—Insuranshares Corporation of Delaware, Bond and Share Trading Corporation, and Burco, Inc.—with aggregate assets of approximately \$2,000,000. During that period virtually all of these assets, like the assets of the investment companies, which had come under the control of the Fiscal Management group, were dissipated by the Northern Fiscal group. By March 1938, two of these investment companies—Insuranshares Corporation of Delaware, and Burco, Inc.—had been placed in receivership, like the investment companies acquired by the Fiscal Management group.

<sup>351</sup> Id., at 1376-7.

<sup>352</sup> Three debenture holders instituted these proceedings, urging among other things that the "net assets of the company are less than 110% of the funded debt of the company" and that the company "has committed acts of bankruptcy \* \* \* in that within the past four months the investment company "conveyed and transferred various moneys amounting in the aggregate to a sum in excess of \$880,000 to Continental Securities Corporation with intent to hinder, delay, and defraud the creditors" of the investment company. (*In the matter of Reynolds Investing Company, Inc.*, United States District Court, District of New Jersey, May 18, 1938.)

<sup>353</sup> See *supra*, p. 357 et seq.

## 2. ACQUISITION OF CONTROL OF INSURANSHARES CORPORATION OF DELAWARE

The first investment company to come under the control of the Northern Fiscal group was Insuranshares Corporation of Delaware, an investment company of the general management type. The history of that investment company prior to the time when the Northern Fiscal group acquired control will be briefly outlined.

Insuranshares Corporation of Delaware had been organized under the laws of Delaware on July 31, 1928, under the sponsorship, among others, of Sterling Pile, Edward B. Twombly, and The Goldman Sachs Trading Corporation.<sup>354</sup> The authorized capital of Insuranshares Corporation of Delaware consisted of Class A common stock entitled to one vote per share in the election of directors and to a preference of \$20 per share on liquidation of the company; and Class B common stock entitled to three votes per share in the election of directors,<sup>355</sup> and junior to the Class A stock upon liquidation.

Insuranshares Corporation of Delaware sold 250,000 shares of its Class A stock to The Goldman Sachs Trading Corporation for \$5,000,000 and 500,000 shares of such stock to the public for \$10,000,000.<sup>356</sup> All of the 500,000 shares of the Class B common stock of Insuranshares Corporation of Delaware were sold for \$50,000 to Insuranshares and General Management Company<sup>357</sup> (controlled by the sponsors of Insuranshares Corporation of Delaware),<sup>358</sup> which held the management contract with Insuranshares Corporation of Delaware. In March 1930, The Goldman Sachs Trading Corporation sold its entire block of the Class A common stock of Insuranshares Corporation of Delaware to other investment companies known as the United Founders Corporation group.<sup>359</sup> On May 31, 1931, Insuranshares Corporation of Delaware was recapitalized under a plan whereby a reverse split-up of stock was effected, the 750,000 outstanding shares of Class A stock were exchanged for 375,000 shares of new common stock and the 500,000 outstanding Class B shares were similarly exchanged for 250,000 shares of Class B common.<sup>360</sup> At

<sup>354</sup> Public Examination, Allied General Corporation, at 4946, 4948-50, 5046, 5051. Among the other organizers of the company were Schoellkopf, Hutton & Pomeroy and Edward S. Goodwin of Goodwin, Beach & Co. of Hartford, Connecticut.

<sup>355</sup> Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibit No. 1908.

<sup>356</sup> Public Examination, Allied General Corporation, at 5046, 5048; Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibit No. 1908; Public Examination, First Income Trading Corporation, et al., at 1054.

<sup>357</sup> Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibit No. 1908.

<sup>358</sup> See note 356, *supra*.

<sup>359</sup> *Op. cit. supra*, note 1, at 1055. This group included United Founders Corporation, American Founders Corporation, International Securities Corporation of America, American & General Securities Corporation, Second International Securities Corporation of America, United States & British International Corporation, Founders General Corporation, and American & Continental Corporation. (Stenographer's minutes, *Benedict v. Seagrave*, Supreme Court of the State of New York, New York County, Special Term, Part III, Index No. 45607-1933, at 1382.)

<sup>360</sup> *Moody's Manual of Investments, Banks, etc.*, 1932, at 2479. The new common stock was entitled to 85% of the corporate assets on any dissolution of the company and the new B stock was entitled to the remainder of such assets. The voting rights of the shares remained unchanged. (*Ibid.*)

the same time an additional 93,750 shares of Class A common stock were offered by the Insuranshares Corporation of Delaware to its common-stock holders at \$9 a share. As a result of this offering, an additional \$843,750 was raised by the company, increasing the total capital contributed by its stockholders to \$15,893,750.<sup>361</sup>

As at April 1932, the total assets of Insuranshares Corporation of Delaware had a market value of approximately \$4,500,000,<sup>362</sup> indicating a loss, realized and unrealized by the company, of approximately \$11,000,000. However, the company's portfolio at that time consisted entirely of dividend-paying stocks of well-known banks and insurance companies.<sup>363</sup> By April 21, 1932, the United Founders Corporation group had acquired 161,605 shares of the new common stock of Insuranshares Corporation of Delaware, or 34% of the 468,750 shares then outstanding, and had also acquired a majority of the voting stock of Insuranshares and General Management Company which held all of the Class B stock of Insuranshares Corporation of Delaware.<sup>364</sup> On that date the United Founders Corporation group contracted to sell these holdings and certain other securities to Insurance Equities Corporation for a total consideration of approximately \$2,000,000.<sup>365</sup> This price was approximately equal to the asset value of the securities to be sold and was \$600,000 in excess of the market value of such securities.<sup>366</sup> The contract provided that Insurance Equities Corporation was to pay \$450,000 on the closing date of the contract and the balance of the purchase price in two equal installments of \$550,004 and \$819,297, due on May 31, 1932, and July 31, 1932, respectively.<sup>367</sup>

Insurance Equities Corporation which was then controlled by one Frank Cohen, a vice president of Lloyds Casualty Company of New York,<sup>368</sup> was insolvent at the time of the making of this contract,<sup>369</sup> and the United Founders Corporation group had not made any investigation of the financial condition<sup>370</sup> of the purchaser. Associated with Mr. Cohen in this venture was Julius H. Barnes, chairman of the Chamber of Commerce of the United States. Frank Cohen intended to use the assets of Insuranshares Corporation of Delaware to finance the acquisition of control of several casualty and life insurance companies which were then in a precarious financial condition,<sup>371</sup> with the

<sup>361</sup> Op. cit. supra, note 1, Commission's Exhibit No. 64.

<sup>362</sup> Id., at 1063.

<sup>363</sup> Id., at 1059.

<sup>364</sup> Id., Commission's Exhibit No. 98.

<sup>365</sup> Ibid.

<sup>366</sup> Stenographer's minutes, *Benedict v. Scaggrave*, Supreme Court of the State of New York, New York County, Special Term, Part III, Index No. 45607-1933, Exhibit No. 22.

<sup>367</sup> Op. cit. supra, note 1, at 1057, and Commission's Exhibit No. 98. As Insurance Equities Corporation made its payments the Founders group was to release to it a block of the Insuranshares Corporation of Delaware common stock, but the Insuranshares and General Management Company stock was to be held by the Founders Group as collateral until Insurance Equities Corporation paid all of its installments on the purchase price. (Ibid.)

<sup>368</sup> Id., at 1112.

<sup>369</sup> Op. cit. supra, note 366, at 533, 535-6.

<sup>370</sup> Op. cit. supra, note 1, at 796.

<sup>371</sup> Id., at 1666. Julius H. Barnes testified:

Q. The program that has been referred to of acquiring a number of insurance companies and then the consolidation or merger of them, the companies that were referred to were companies that either were in receivership, or facing receivership, or companies which were in a distressed condition. Isn't that correct, in general?

A. Those were the only kind of companies for sale.

ultimate purpose of merging such companies into a single large casualty and into a group of life insurance companies.<sup>372</sup> Mr. Cohen testified that "the only interest [he] had in these investment trusts was to be able to carry through a program on these insurance companies."<sup>373</sup> This purpose was made known to the United Founders Corporation group prior to the making of the agreement for the sale of control of Insuranshares Corporation of Delaware.<sup>374</sup>

On May 3, 1932 the closing of the contract for the sale of control of Insuranshares Corporation of Delaware took place. On the morning of that day, the United Founders Corporation group placed Insurance Equities Corporation in control of the directorate of Insuranshares Corporation of Delaware before the down payment of \$450,000 was made.<sup>375</sup> The nominees of Insurance Equities Corporation on the board of directors of Insuranshares Corporation of Delaware immediately caused Insuranshares Corporation of Delaware to purchase for \$650,000 a block of the preferred and common stock of Insurance Equities Corporation. In order to obtain part of the funds necessary to pay for this Insurance Equities Corporation stock, Insuranshares Corporation of Delaware was compelled to borrow from a bank and hypothecate as collateral a substantial portion of its portfolio securities.<sup>376</sup> This collateral was later sold by the bank to satisfy the loan.<sup>377</sup> With the funds obtained by this loan, Insurance Equities Corporation late in the afternoon of May 3, 1932 paid to the United Founders Corporation group the \$450,000 down payment required under the contract. The initial payment, therefore, on the contract to acquire control came from the sale of portfolio securities of Insuranshares Corporation of Delaware. To "reimburse" this investment company for its portfolio securities it was caused to take into its portfolio the preferred and common stock of Insurance Equities Corporation which in turn controlled Insuranshares Corporation of Delaware. The method of acquiring control employed in May 1932 and the circular ownership that resulted was similar to the technique employed in the latter part of 1937 by the Fiscal Management group in acquiring control of First Income Trading Corporation, Continental Securities Corporation, and Reynolds Investing Company, Inc., and was similar to the technique employed by the Northern Fiscal group in the latter part of 1937 in acquiring control of Insuranshares Corporation of Delaware.

Thereafter, in order to obtain the necessary funds to meet the subsequent payments due on its purchase contract, Insurance Equities Corporation caused Insuranshares Corporation of Delaware to liquidate virtually its entire portfolio of securities of well-known dividend paying insurance company and bank stocks and to purchase from Insurance Equities Corporation to replace these securities, large blocks of nondividend paying stocks of various casualty and life insurance companies many of which subsequently went into receiver-

<sup>372</sup> Id., at 286-7, 664, 673, 1609.

<sup>373</sup> Id., at 1254.

<sup>374</sup> Id., at 286, 664.

<sup>375</sup> Op. cit. supra, note 366, at 609, 652, 1569.

<sup>376</sup> Op. cit. supra, note 1, at 1059, and Commission's Exhibit No. 99.

<sup>377</sup> Id., at 1058.

ship.<sup>378</sup> With the funds derived by these sales of insurance company stocks to Insuranshares Corporation of Delaware, Insurance Equities Corporation by August 1933 had been enabled to pay to the United Founders Corporation group all but \$175,000 of the contract price for control of Insuranshares Corporation of Delaware.

Harry M. Blair, who became director of Insuranshares Corporation of Delaware on September 20, 1933,<sup>379</sup> under circumstances which will be described later,<sup>380</sup> testified as follows with reference to the use of the funds of Insuranshares Corporation of Delaware by Insurance Equities Corporation and Frank Cohen:<sup>381</sup>

Q. Well, then what did Cohen and Barnes and the Board of Directors continue doing?

A. They continued selling good dividend paying stocks in insurance companies and bank stocks, liquidated them, and buying what they supposed would be control in certain insurance companies, paying control prices for minority holdings on mostly nondividend paying stocks.

Q. Now, most of those stocks came from Cohen and Barnes personally; isn't that so?

Q. Well, I don't say that they came from them personally, but they went out to buy control of this, that, or the other company, sold securities from Insuranshares that were paying dividends, at the lowest price up to that date in the history of the insurance company stocks, and buying minority holdings in insurance—life insurance companies or other insurance companies that were not, as a rule, paying dividends.

George E. Devendorf, a vice president of American Founders Corporation (an investment company in the United Founders Corporation group) at the time of the sale of control of Insuranshares Corporation of Delaware to Insurance Equities Corporation, testified that the proceeds of the liquidated portfolio securities of Insuranshares Corporation of Delaware had been used at least in part to pay the United Founders Corporation group for its transfer of control of Insuranshares Corporation of Delaware.<sup>382</sup>

<sup>378</sup> For example, Insuranshares Corporation of Delaware had invested \$247,500 in the stock of Lloyds Insurance Company of New York which went into receivership on August 17, 1933. (Id., Commission's Exhibit No. 99; *Moody's Manual of Investments, Banks, etc.*, 1934, at 1104.) \$144,500 was invested in the stock of Missouri State Life Insurance Company which went into receivership in 1933. (Op. cit. supra, note 1. Commission's Exhibit No. 99; *Moody's Manual of Investments, Banks, etc.*, 1934, at 2008.)

<sup>379</sup> Op. cit. supra, note 1, at 1051.

<sup>380</sup> See infra, p. 442.

<sup>381</sup> Op. cit. supra, note 1, at 1059.

<sup>382</sup> Mr. Devendorf testified (Public Examination, General Investment Corporation, at 15046-7; op. cit. supra, note 1, Commission's Exhibit Nos. 99 and 100):

Q. Did you participate in the negotiations which looked forward to the sale of control of Insuranshares Corporation of Delaware by the Founders group to these two new sponsors, Barnes and Frank Cohen?

A. Yes.

Q. And after Barnes and Cohen got into that picture they had bought control of Insuranshares Corporation of Delaware from the Founders on the installment plan, isn't that so?

A. On time payments.

Q. You are not squeamish about installment plan, are you?

A. No.

Q. It subsequently turned out that Mr. Barnes and Mr. Cohen made these payments with receipts that they had obtained from the sale of \* \* \* securities to Insuranshares Corporation of Delaware, isn't that so?

A. At least partly; yes.

Q. At least a good part of it, isn't that so?

A. I don't remember just what part of it it was.

A more detailed discussion of the acquisition of control of Insuranshares Corporation of Delaware by Frank Cohen and Insurance Equities Corporation is given in Ch. IV of this part of the report.

As has been stated, Insurance Equities Corporation was, because of its access to the funds of Insuranshares Corporation of Delaware, able to complete all but \$175,000 of its installment payments due to the United Founders Corporation group.<sup>383</sup> In August 1933, Insurance Equities Corporation failed to meet its final payment of \$175,000 and the United Founders Corporation group sold its note and the collateral consisting of the controlling block of stock of Insuranshares and General Management Company, which in turn held all of the Class B stock of Insuranshares Corporation of Delaware, to one John H. Orgill, a Cleveland attorney, for \$100,000.<sup>384</sup> Mr. Orgill then designated Harry M. Blair as his representative on the board of directors of Insuranshares Corporation of Delaware.<sup>385</sup>

By December 31, 1933, all of the representatives of Insurance Equities Corporation, including Frank Cohen, had resigned from the board of directors of Insuranshares Corporation of Delaware. At that date, the total assets of Insuranshares Corporation of Delaware had a value of approximately \$300,000,<sup>386</sup> as compared with the approximately \$4,500,000 of assets of the company as at April 1932, when Insurance Equities Corporation took control, and as compared with the \$15,000,000 originally contributed by the public to Insuranshares Corporation of Delaware. In the period of approximately one year and a half during which Insurance Equities Corporation controlled Insuranshares Corporation of Delaware, the latter company was caused to liquidate its entire portfolio of well-known insurance company stocks at a realized loss, on the basis of original cost, of approximately \$11,000,000;<sup>387</sup> and these portfolio securities were replaced with nondividend paying stocks of the lesser known casualty and life insurance companies. Had the securities which were in the portfolio of Insuranshares Corporation of Delaware prior to the passage of its control to Insurance Equities Corporation been kept intact, those securities would have had a value of about \$7,000,000 at the end of 1936.<sup>388</sup>

Early in 1937, Insuranshares Corporation of Delaware received from the United Founders Corporation group approximately \$320,000<sup>389</sup> in settlement of a suit brought against the United Founders Corporation group to recover the amount paid by Insurance Equities Corporation to United Founders Corporation group on the contract to purchase control of Insuranshares Corporation of Delaware, which payments were made with the cash realized by the sale of the portfolio securities of Insuranshares Corporation of Delaware.<sup>390</sup> Of

<sup>383</sup> Op. cit. supra, note 1; Commission's Exhibit No. 100.

<sup>384</sup> Op. cit. supra, note 366, at 1563.

<sup>385</sup> Op. cit. supra, note 1, at 1051.

<sup>386</sup> Id., at 1063-4. Mr. Blair testified:

Q. Well, after they got through liquidating, what was the value of that portfolio?  
A. I think we could have liquidated in October, November, December 1933, for about \$250,000 to \$300,000.

Q. So that the portfolio which, if they had locked it up at that time, you said, in October 1933, was only worth a quarter of a million dollars, is that so?

A. Under the hammer, that is all we could have gotten for it.

<sup>387</sup> Id., at 1062-3, and Commission's Exhibit No. 99.

<sup>388</sup> Id., at 1063.

<sup>389</sup> Id., at 1069.

<sup>390</sup> The suit was settled by the payment of \$750,000 by American General Corporation (successor by consolidation of the United Founders Corporation group of companies), and of this amount approximately \$320,000 was received by Insuranshares Corporation of Delaware, \$239,605 by counsel (39 Col. L. R. 814 [1939]), and the remainder by Insurance Equities Corporation.



this sum received in settlement, \$300,000 was invested by Insuranshares Corporation of Delaware in 21,500 certificates of beneficial interest in New England Fund, an open-end investment trust of the general management type.<sup>391</sup>

By December 1937, Insuranshares Corporation of Delaware had total assets of approximately \$800,000<sup>392</sup> and had outstanding 284,032 shares of its common stock.<sup>393</sup> The original purchasers of these shares had contributed approximately \$13,778,931 net to Insuranshares Corporation of Delaware so that as at December 31, 1937, the stockholders<sup>394</sup> had experienced a loss, realized and unrealized, of approximately \$13,000,000 on their investment.<sup>395</sup>

Of 284,032 shares of the common stock of Insuranshares Corporation of Delaware outstanding on December 31, 1937, an aggregate of approximately 80,000 was held<sup>396</sup> by Mr. Blair who was president and a director of the company, by the Continental Bank & Trust Company of New York, and by three Philadelphia banks.<sup>397</sup> Mr. Blair had acquired 4,000 shares of the common stock of Insuranshares Corporation of Delaware in the open market<sup>398</sup> at a cost of \$3,200 and, in addition, he and C. J. Simmons, another director and the counsel for Insuranshares Corporation of Delaware, were jointly obligated to purchase an additional 10,000 shares of this common stock from a certain bank at a cost of \$20,000.<sup>399</sup> Thus Mr. Blair, in effect, was the owner of 14,000 shares of the common stock of Insuranshares Corporation of Delaware which had cost him \$13,200.

In September 1937, Mr. Solomont and his associates through one Lorimer A. Davidson had commenced negotiations on behalf of the Fiscal Management group with Mr. Blair for the acquisition of control of Insuranshares Corporation of Delaware.<sup>400</sup> At that time, Mr. Blair refused to entertain the offer of Mr. Davidson because the latter was unwilling to disclose his principal.<sup>401</sup> Subsequently, the principal was disclosed as Mr. Beverly. Mr. Blair testified:

A. \* \* \* He came in and said, "Mr. Blair, I know a group that is building a great big super investment trust and they are buying up these little trusts. You cannot afford to run the trust with the big overhead, why don't you sell out to them and make your stockholders more money?" Well, he talked to a deaf ear for the first four or five times.

Q. Why?

A. Because, frankly, I was drawing a \$7,500 a year salary and I could use it.

<sup>391</sup> Op. cit. supra, note 1, at 1093.

<sup>392</sup> Id., Exhibit 64.

<sup>393</sup> Id., at 1070, and Commission's Exhibits Nos. 53 and 64. By this time Insuranshares and General Management Company had been liquidated and its holdings of all of the Class B stock of Insuranshares Corporation of Delaware had been acquired and retired by the Insuranshares Corporation of Delaware. (*Moody's Manual of Investments, Banks, etc.*, 1938, at 1525, and op. cit. supra, note 1, at 1510.)

<sup>394</sup> As at December 18, 1937, there were 4,658 shareholders of Insuranshares Corporation of Delaware. (Op. cit. supra, note, Commission's Exhibit No. 53, at 3.)

<sup>395</sup> Id. Commission's Exhibit No. 64. The total capital raised by the company was \$15,893,750, but the company as at December 31, 1937, had returned to its stockholders by way of dividends and repurchases of its shares \$2,014,817. (Ibid.)

<sup>396</sup> Id., Commission's Exhibit No. 53.

<sup>397</sup> Id., at 1106-7.

<sup>398</sup> Id., at 1071.

<sup>399</sup> Id., at 1072-3.

<sup>400</sup> Id., at 779-84.

<sup>401</sup> Id., at 1094-5.



But as the trouble thickened I said, "Now who is buying these securities and investment trusts?" He said, "I am not privileged to tell." I said, "I am not going to talk to you." I said I wasn't going to see a Frank Cohen used on me. We used that expression, "pulling a Frank Cohen." Finally, he came over one day and he said, "My associates told me I could tell you in confidence the principals." I said, "Why tell me?" He said it was Alexander Beverly, of Toronto.

Mr. Blair made an investigation of Mr. Beverly and was informed that his financial responsibility was between \$250,000 and \$500,000.<sup>402</sup> Thereafter Mr. Blair agreed to arrange for the sale, ostensibly to Mr. Beverly, by the larger stockholders of Insuranshares Corporation of Delaware, of their holdings and also agreed to turn over all the offices and directorships of Insuranshares Corporation of Delaware to Mr. Beverly and his associates.<sup>403</sup>

Mr. Beverly in reality was representing the Fiscal Management group in these negotiations. In connection with this transaction, S. Leo Solomont, in behalf of the Fiscal Management group; had requested Paine, Webber & Co. to liquidate the investment of Insuranshares Corporation of Delaware in New England Fund,<sup>404</sup> then valued at \$300,000 to \$320,000,<sup>405</sup> and to advance an additional \$40,000 to \$50,000, with the other portfolio securities of Insuranshares Corporation of Delaware as collateral.<sup>406</sup> Paine, Webber & Co. agreed to make this advance and issued three checks totaling \$310,000 payable to S. Leo Solomont.<sup>407</sup> Although these checks were held by a representative of Paine, Webber & Co. for delivery to S. Leo Solomont, they were never used because the Fiscal Management group refused to consummate its deal with Mr. Blair.<sup>408</sup>

Thereafter, in December 1937, when Mr. Solomont and his associates determined independently to acquire control of investment companies for their own account, they first directed their attention to the acquisition of control of Insuranshares Corporation of Delaware. Negotiations for the purchase of Insuranshares Corporation of Delaware were, in this instance, also, carried on by Lorimer A. Davidson, who represented that the principals in these negotiations were the same "fellows \* \* \* without Ferretti."<sup>409</sup> Although Mr. Blair was assured that he was dealing with the same persons who had

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<sup>402</sup> Id., Commission's Exhibit No. 101.

<sup>403</sup> Id., Commission's Exhibit No. 88.

<sup>404</sup> Id., at 272-4.

<sup>405</sup> Ibid.

<sup>406</sup> Id., at 272.

<sup>407</sup> Id., at 276-8 and Commission's Exhibit No. 28.

<sup>408</sup> Id., at 781-2. It appears that the Fiscal Management group was unwilling to "go through with the contract" for the purchase of the stock of Insuranshares Corporation of Delaware, since the cash balance of the company had been reduced to \$9,000 during the course of the negotiations. By the time of closing of the contract, \$27,000 had been paid to Mr. Simmons in legal fees in connection with suits brought by and against Insuranshares Corporation of Delaware involving the activities of Insurance Equities Corporation in the latter's management of Insuranshares Corporation of Delaware. (Id., at 1098 and Commission's Exhibit No. 98.)

<sup>409</sup> Id., at 1105.

previously approached him in October 1937, Mr. Beverly's association with the transaction was not emphasized. On the contrary, the persons introduced in December 1937 as the principals in the transaction were Messrs. Robb, Morris, and Solomont. Mr. Blair testified that he was particularly impressed with Mr. Robb: <sup>410</sup>

Q. Was Beverly's name mentioned the second time?

A. Well, I was told it was the same group. Now, I don't think we ever emphasized that the day they came down to make that—to close that contract, I think it was October 21st, Mr. Robb made an especially good impression on me.

Q. What did he say that impressed you?

A. Oh, the general thing. You know, you judge a man by his appearance, and so forth.

Q. What?

A. First by his appearance, by the way he comports himself. I had quite a conversation with him. I happened to know some people in Boston that he knew and we exchanged notes. I was really impressed. He was the one man that I got best acquainted with.

On December 15, 1937, Mr. Blair agreed to sell his holdings and to cause the other large stockholders of Insuranshares Corporation of Delaware, the Continental Bank and Trust Company of New York, and other banks located in Philadelphia to sell their holdings of the common stock of Insuranshares Corporation of Delaware to Thomas W. Morris. Mr. Morris agreed to purchase an aggregate of 78,260 shares of the common stock of Insuranshares Corporation of Delaware at a price of \$3.60 a share and also agreed to pay to Mr. Blair a commission of \$10,091 for his services in "arranging that sale \* \* \* to me of this stock." <sup>411</sup> Both Mr. Morris and the sellers of the stock were aware that the then liquidating value of the stock to be sold was \$2.87 per share <sup>412</sup> so that Mr. Blair and the other large-selling stockholders of Insuranshares Corporation of Delaware were conscious of the fact that Mr. Morris was willing to pay a total premium above the asset value of their shares of approximately \$78,000.

That Mr. Morris was paying this price solely to obtain control is evident from the fact that although the total number of shares he had agreed to purchase constituted only approximately 28% of the outstanding stock of Insuranshares Corporation of Delaware, he insisted upon the resignation of all the existing directors and officers of the company and upon their replacement by his own nominees. Mr. Blair and the other stockholders selling their shares acceded to this demand. <sup>413</sup> Mr. Blair also agreed that the 21,500 shares of New England Fund held by Insuranshares Corporation of Delaware would be converted into cash prior to the closing date of the

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<sup>410</sup> Id., at 1105-6.

<sup>411</sup> Id., Commission's Exhibit No. 53.

<sup>412</sup> Ibid.

<sup>413</sup> Ibid.

contract.<sup>414</sup> The fact that Mr. Morris agreed to pay this substantial premium on a minority block of the company's stock, his evident insistence upon obtaining control of the management of the company, and his demand that the New England Fund stock be converted into cash prior to the date of the closing, might have suggested that Mr. Morris may have intended to recoup his investment in the company in a manner detrimental to the interest of the company's stockholders. Yet Mr. Blair took no steps to protect the majority stockholders of Insuranshares Corporation of Delaware, who it will be recalled, had already suffered tremendous losses as a result of a prior change in the management of their company.<sup>415</sup> Mr. Blair when examined on that aspect testified: <sup>416</sup>

Q. Did you ask these people whether they would make the same offer to other stockholders so that they could get the same price and get out?

A. No, I didn't.

Q. Did you ask for any representation on the Board of Directors, the new Board?

A. No, I didn't want it.

Q. Did you get any agreement in writing that they were not going to change the nature of the portfolio?

A. No.

The closing date for the contract was set for December 21, 1937.<sup>417</sup> Prior thereto Paine, Webber & Co. had agreed to advance to Mr. Solomont \$310,000.<sup>418</sup> Of this amount, \$270,000 was to constitute an advance cash payment on 21,500 shares of beneficial interest in New England Fund, which were owned by Insuranshares Corporation of Delaware.<sup>419</sup> Paine, Webber & Co. were informed that these shares were to be liquidated for the account of Insuranshares Corporation of Delaware and the proceeds were to be invested in "a Canadian investment company."<sup>420</sup> The balance of \$40,000, to the

<sup>414</sup> This was not done. However, on December 16, 1937, five days before the closing of the contract for the sale of control of Insuranshares Corporation of Delaware, the board of directors of that corporation, all of whom were either the owners or represented the owners of the stock which was to be sold to the Northern Fiscal group, "authorized the New England Fund to transfer certificates of beneficial interest of said New England Fund standing in the name of Insuranshares Corporation of Delaware and aggregating 21,500 shares to S. Leo Solomont," and "further that they shall not be placed in the name of S. Leo Solomont until he is duly elected and qualified as treasurer" of Insuranshares Corporation of Delaware. (Id., Commission's Exhibit No. 52.) As will be seen infra, the New England Fund shares were used by the Northern Fiscal group to derive the major part of the funds necessary to purchase control of Insuranshares Corporation of Delaware.

<sup>415</sup> See supra, p. 443.

<sup>416</sup> Op cit. supra, note 1, at 1113-4.

<sup>417</sup> Id., Commission's Exhibit No. 53.

<sup>418</sup> Id., at 350-1.

<sup>419</sup> Id., at 351-3. Mr. Paine testified that he could not consider the investment in New England Fund as collateral for a loan since it was not listed security. He suggested to Mr. Solomont that the board of directors of Insuranshares Corporation of Delaware authorize the liquidation of this stock. The transfer of the shares in New England Fund to Paine, Webber & Co. therefore constituted merely a transfer for the purposes of their sale on behalf of Insuranshares Corporation of Delaware. (Id., at 352.)

In order to have these shares in proper negotiable form, the board of directors representing the old management, on December 16, 1937, provided that the 21,500 shares of beneficial interest in New England Fund be placed in the name of S. Leo Solomont as soon as he was elected and qualified as treasurer of Insuranshares Corporation of Delaware. (Id., at 1109-11.)

<sup>420</sup> Id., at 1701-2.

knowledge of Paine, Webber & Co., was to constitute a loan to be secured by "other securities" of Insuranshares Corporation of Delaware as collateral.<sup>421</sup>

On December 21, 1937 checks of Paine, Webber & Co. totaling \$310,000 were made payable to Mr. Blair and the other sellers of the stock of Insuranshares Corporation of Delaware.<sup>422</sup> Immediately upon the payment for this stock, the representatives of the old management resigned, in accordance with the terms of the contract of sale, and the nominees of the Northern Fiscal group were placed on the board.<sup>423</sup> The new board of directors of Insuranshares Corporation of Delaware, using the same technique employed by the Fiscal Management group (with whom Messrs. Solomont, Robb, and Morris had been associated) in connection with their acquisition of control of investment companies, immediately caused that investment company to purchase 5,000 shares of preferred stock of Northern Fiscal Corporation, Ltd., the personal company of Messrs. Solomont, Robb, and Morris at \$100 per share for a total of \$500,000 from Arthur Quint, a representative of S. Leo Solomont.<sup>424</sup> Portfolio securities of Insuranshares Corporation, valued at \$500,000, including the New England Fund shares, were turned over to Mr. Quint, as consideration for the 5,000 shares of preferred stock of Northern Fiscal Corporation, Ltd.,<sup>425</sup> sold to Insuranshares Corporation of Delaware.

Mr. Quint immediately assigned these portfolio securities to Messrs. Solomont and Robb with the direction that they liquidate these securities, retain \$310,000 which constituted the amount of the advance made by Paine, Webber & Co., and return the balance to Northern Fiscal Corporation, Ltd.<sup>426</sup> These portfolio securities were removed on December 21, 1937 from the vault of Insuranshares Corporation of Delaware and were transferred to Paine, Webber & Co. for the account of Insuranshares Corporation of Delaware in the name of Solomont and Robb.<sup>427</sup>

Paine, Webber & Co. liquidated these securities, deducted its \$310,000 advance and transmitted a balance of \$152,321.40 to Northern

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<sup>421</sup> Id., at 351-3. These "other securities" were already in marketable form. (Id., at 1111.) The contract had permitted the new management between December 15 and December 21, 1937, to check the portfolio securities of the investment company and provided that these securities be in bearer form. (Id., Commission's Exhibit No. 53.)

<sup>422</sup> Id., Commission's Exhibits Nos. 49 and 53.

<sup>423</sup> The new officers and directors were Ralph H. Robb, S. Leo Solomont, Harold J. Tracy, D. C. Morgan, Thomas F. Stanton, Thomas W. Morris, and Arthur Quint. Mr. Robb was elected president of the company and Mr. Solomont was elected treasurer. (Id., Commission's Exhibit No. 52.)

<sup>424</sup> Mr. Solomont and his associates had organized Northern Fiscal Corporation, Ltd., in Canada on December 14, 1937, as a personal holding company, of which S. Leo Solomont was president, Ralph H. Robb was vice president, and Thomas W. Morris was treasurer. Ten thousand shares of common stock were authorized, of which 9,997 shares were issued to Priscilla French, who was an employee of Messrs. Morris and Robb, in consideration for 3,000 shares of Amm Gold Mines, Ltd., 6,000 shares of Cook Lake Gold Mines, Ltd., and \$1,000 in cash. (Id., Commission's Exhibit No. 54.) The remaining three shares of common stock were issued to Messrs. Solomont, Robb, and Morris.

<sup>425</sup> Id., Commission's Exhibit No. 48.

<sup>426</sup> Ibid.

<sup>427</sup> Id., Commission's Exhibits Nos. 48 and 50.

Fiscal Corporation, Ltd.<sup>428</sup> In addition to this \$152,321.40, as has been stated, the 78,260 shares of Insuranshares Corporation of Delaware common stock were also transferred to Northern Fiscal Corporation, Ltd., by Messrs. Robb, Morris, and Solomont, as consideration for the sale of 5,000 shares of its own preferred stock to Insuranshares Corporation of Delaware.<sup>429</sup>

To sum up the transaction, portfolio securities of Insuranshares Corporation of Delaware, valued at \$500,000, were liquidated and \$310,000 of the proceeds were used by the Northern Fiscal group to acquire control of Insuranshares Corporation of Delaware. In place of these liquid portfolio securities, valued at \$500,000, thus removed by the Northern Fiscal group, Insuranshares Corporation of Delaware held 5,000 shares of the preferred stock of Northern Fiscal Corporation, Ltd. This preferred stock of Northern Fiscal Corporation, Ltd., held by Insuranshares Corporation of Delaware represented an interest in a corporation which held, in turn, 78,260 shares or 28% of Insuranshares Corporation of Delaware's common stock, \$152,321 in cash, and various Canadian mining stocks of uncertain value.<sup>430</sup> At the conclusion of these transactions, the portfolio of Insuranshares Corporation of Delaware consisted only of its holdings of the preferred stock of Northern Fiscal Corporation, Ltd., which had no market, and certain other unmarketable blocks of securities of insurance companies and other companies which had been acquired by Insuranshares Corporation of Delaware from Insurance Equities Corporation during the period of the latter's control and management of Insuranshares Corporation of Delaware.

Thus, within a space of five years, from 1932 to 1937, the stockholders of Insuranshares Corporation of Delaware suffered a loss of practically their entire investment in the company as the result of the transfer of its control to Insurance Equities Corporation and thereafter to Northern Fiscal Corporation, Ltd. In each case the new controlling interests paid for their control by the use of the investment

<sup>428</sup> Francis Xavier Mancuso, a former judge of the Court of General Sessions of the County of New York, and Lorimer A. Davidson received \$15,000 as "commissions" for effecting this transaction. (Id., Commission's Exhibit No. 89.) Upon the consummation of the transaction Messrs. Mancuso and Davidson received \$7,500 in cash. (Id., at 791.) Two days after the closing of the contract on December 23, 1937, Messrs. Mancuso and Davidson received the balance in the form of a telegraphic postal money order. (Id., at 792.) Mr. Mancuso denied that there was anything unusual in this practice. He testified (id., at 792) :

Q. Let me understand, when you say cash, do you mean dollars?

A. Currency, actual cash. There were one-hundred-dollar bills—no, there were several five-hundred-dollar bills and one-hundred-dollar bills.

Q. And the second seventy-five hundred dollars you got in a money order; is that it?

A. Western Union Telegraph Company.

Q. Didn't it seem strange to you, Judge, that you were being paid in cash and not by check; did you give these people a receipt for this seventy-five hundred dollars?

A. I think we did. There was nothing strange. As a matter of fact, I understand that is the usual way brokers in those deals are paid, in cash.

Q. By hundred-dollar bills?

A. Five-hundred and one-hundred bills.

However, when Mr. Mancuso received a commission from the same individuals for a subsequent transaction involving the acquisition of control of another investment company, he was paid by check. (See *infra*, p. 452, note 456.) This change in procedure did not, however, arouse Mr. Mancuso's suspicions.

<sup>429</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. 54. In addition, Northern Fiscal Corporation, Ltd., received an assignment of an oil and gas lease consisting of about 127 acres on the G. Anderson survey in Texas. (Ibid.)

<sup>430</sup> See *supra*, pp. 445-6.

company's own assets. Mr. Blair, when examined on that phase of the company's history, testified: <sup>431</sup>

Q. And do the things that have transpired in the last couple of months kind of remind you of the things that transpired in that corporation in 1932?

A. The only difference is in the size.

Q. And the difference in the name; isn't that so?

A. Yes.

Q. Instead of Northern Fiscal Corporation, Ltd., that you have now, all you have to do is substitute the name Insurance Equities Corporation, and you have precisely the same picture in 1932.

A. And other subordinate corporations that followed that.

\* \* \* \* \*

Q. The Northern Fiscal Corporation sold Insuranshares Corporation of Delaware only \$500,000 of its own stock, and in 1932 Insurance Equities Corporation sold Insuranshares Corporation of Delaware \$600,000 of its own stock.

A. \$650,000.

\* \* \* \* \*

Q. They made a loan to make the initial down payment on the contract and then they went in and sold Insurance Equities Corporation stock to Insuranshares Corporation of Delaware and paid off the loan with the bank; isn't that so?

A. They took out of the portfolio of Insuranshares Corporation of Delaware—they took out enough good securities to turn it over to the bank and gave them carte blanche to sell them and pay them.

Q. In the case of the sale of control of Insuranshares Corporation of Delaware in 1938, there was an assignment to Robb-Morris-Solomont to sell enough securities to pay the \$300,000?

A. Yes.

\* \* \* \* \*

Q. And you know that Insurance Equities Corporation which sold the insurance stocks to Insuranshares Corporation of Delaware—that Insurance Equities Corporation was Cohen and Barnes; isn't that so?

A. Practically.

Q. Now, that Insurance Equities Corporation corresponds to the Northern Fiscal Corporation, Ltd., which was the holding company that they organized specifically for the transaction; isn't that so?

A. I think it was.

On June 15, 1938, Insuranshares Corporation of Delaware was placed in receivership. <sup>432</sup>

### 3. ACQUISITION OF CONTROL OF BOND AND SHARE TRADING CORPORATION

After assisting Messrs. Solomont, Robb, and Morris in their acquisition of control of Insuranshares Corporation of Delaware, Francis X. Mancuso and Lorimer A. Davidson continued their activities as "finders" of investment companies on behalf of the Northern Fiscal group. These "finders" testified that they had sought, but without

<sup>431</sup> Op. cit. supra, note 1, at 1053-4, 1058-9, 1064.

<sup>432</sup> On June 15, 1938, a custodial receiver was appointed on the petition of a stockholder to protect the company's assets against further depletion by the Northern Fiscal group. (*The New York Times*, June 16, 1938, p. 33.)

success, to interest Messrs. Morris, Robb, and Solomont in the purchase of Investors Syndicate of Minneapolis, Minnesota,<sup>433</sup> and Utility Equities Corporation.<sup>434</sup> However, in the early part of January 1938, Messrs. Mancusco and Davidson recommended to the Northern Fiscal group the purchase of control of Bond and Share Trading Corporation, an investment company of the general management type.

Bond and Share Trading Corporation, incorporated in Nevada on July 20, 1932, had been sponsored by C. F. Coombs, Frank V. Erwin, and William A. Gutekunst.<sup>435</sup> The authorized capital structure of the company consisted of 200,000 shares of preferred stock with a \$25 par value, 500,000 shares of Class A no par common stock, and 500,000 shares Class B no par common stock. Although both Class A and Class B stock had voting rights, the Class A stock as a class was entitled to one and one-half times the number of votes of the outstanding B stock.<sup>436</sup>

Bond and Share Trading Corporation had raised a total of \$435,475 through the sale of its own securities.<sup>437</sup> Of this amount, \$122,649 had been returned to the stockholders by way of dividends and repurchases by the investment company of its own outstanding securities, so that the net capital contributed to the company was \$312,825.<sup>438</sup> As at January 1938 when negotiations were commenced on behalf of the Northern Fiscal group for the acquisition of control of Bond and Share Trading Corporation, the assets of the investment company were \$231,915,<sup>439</sup> and there were outstanding 2,292 shares of preferred stock, 71,661 shares of Class A common stock, and 302,400 shares of Class B common stock.<sup>440</sup>

On January 7, 1938 Mr. Gutekunst and his associates contracted to sell to Insuranshares Corporation of Delaware, which was controlled at this time by the Northern Fiscal group, 36,000 shares of Class A common stock and 302,400 shares of the Class B common stock of Bond and Share Trading Corporation for \$153,500.<sup>441</sup> The contract provided that the members of the old board of directors would resign and that their places would be taken by nominees of the new management.<sup>442</sup> In addition, representatives of the new management were to be given an opportunity during the period prior to the consummation of the contract to check the securities in the portfolio of Bond and Share Trading Corporation.<sup>443</sup>

Simultaneously, Mr. Gutekunst entered into a "separate agreement" with the Northern Fiscal group, which provided that, immediately upon the consummation of the contract for the sale of control of Bond and Share Trading Corporation, the new management was to sell

<sup>433</sup> Op. cit. supra, note 1, at 805-6, 814-20.

<sup>434</sup> Id., at 803-4, 823.

<sup>435</sup> Id., at 1117. Messrs. Coombs, Erwin, and Gutekunst had been associated with the United Founders Corporation group, Messrs. Coombs and Erwin in the capacity of sponsors.

<sup>436</sup> *Moody's Manual of Investments, Banks, etc.*, 1937, at 2262.

<sup>437</sup> Op. cit. supra, note 1, Commission's Exhibit No. 64.

<sup>438</sup> Ibid.

<sup>439</sup> Id., Commission's Exhibit No. 103.

<sup>440</sup> Id., Commission's Exhibit No. 102.

<sup>441</sup> Id., Commission's Exhibit No. 103.

<sup>442</sup> Id., Commission's Exhibit No. 102.

<sup>443</sup> Ibid.



to Mr. Gutekunst portfolio securities of that company valued at \$131,000.<sup>444</sup>

On January 8, 1938, the closing date of the contract, Northern Fiscal Corporation, Ltd., the personal holding company of Messrs. Solomont, Robb, and Morris,<sup>445</sup> issued an uncertified check for \$131,000 to the order of Insuranshares Corporation of Delaware.<sup>446</sup> Insuranshares Corporation of Delaware endorsed the check over to Mr. Gutekunst in part payment for the control block of stock of Bond and Share Trading Corporation.<sup>447</sup> Although ostensibly this control block of stock of Bond and Share Trading Corporation was purchased on behalf of Insuranshares Corporation of Delaware, actually Northern Fiscal Corporation, Ltd. was the principal in this transaction and acquired the control block of stock of Bond and Share Trading Corporation.<sup>448</sup>

As part of the same transaction,<sup>449</sup> representatives of the Northern Fiscal group were elected, "just for purposes of the closing,"<sup>450</sup> as directors of Bond and Share Trading Corporation to replace the old management.<sup>451</sup> They immediately authorized the sale of \$131,000 worth of the liquid portfolio securities of Bond and Share Trading Corporation to Mr. Gutekunst,<sup>452</sup> pursuant to the "separate understanding" entered into between the Northern Fiscal group and Mr. Gutekunst. Mr. Gutekunst paid for these securities by endorsing over to Bond and Share Trading Corporation the uncertified check of \$131,000 which he and his associates had received in payment for their control block of stock in Bond and Share Trading Corporation.<sup>453</sup>

<sup>444</sup> Id., at 1121.

<sup>445</sup> See note 424, *supra*.

<sup>446</sup> Op. cit. *supra*, note 1, at 1127-1128. Mr. Gutekunst testified as follows with respect to the use of the uncertified check (id., at 1129):

Q. I say, was the reason why you didn't insist on certification of this check because you didn't expect that you would hold onto the check very long?

A. Well, I believe that there was a distinct possibility that we would be buying securities in view of the fact that in the Insuranshares of Delaware they insisted that the securities they sold were frozen and could not be liquidated otherwise.

<sup>447</sup> Id., at 1128. In addition, \$22,000 in cash was paid for the balance, of which \$10,000 was returned immediately to the corporation in payment for the purchase of stamps to cover the transfer. (Id., at 1130.)

<sup>448</sup> Id., Commission's Exhibit No. 52.

<sup>449</sup> Mr. Gutekunst testified (id., at 1124):

Q. Now had you received your check prior to your resignation?

A. Everything was more or less put on the table and they were going over the accounting—that is, the counting of securities and the inspection of the money, and the cash and checks and that sort of thing while this transaction period was on.

<sup>450</sup> Id., at 1123.

<sup>451</sup> These directors, Richard J. McReady, Abraham C. Wolf, and John S. Mead, acted as directors for this one meeting held on January 8, 1938. (Id., at 1122-7.) Mr. Gutekunst testified (id., at 1131):

Q. Were you at all suspicious at the time that this closing took place and these three men came out of nowhere and were supposed to go on the board for just the duration of a meeting?

A. I didn't like it, but it seemed to me that those things had happened before. It seemed to me that some time, a great many years ago, that I had been on the board for a very short time and I never could see the reason for it and don't yet. I didn't like it and so said.

<sup>452</sup> Id., Commission's Exhibit No. 103. These shares included 21,000 shares of the Class A stock of St. Joe Consolidated Mines Company, 95,000 shares of the common stock of St. Joe Consolidated Mines Company, 14,300 shares of Gold Circle Consolidated Mines, 7,000 shares Como Mines, 3,200 shares of Class A Hendrick Hudson Distilling Co., 3,400 shares of the common stock of Hendrick Hudson Distilling Co., 262 shares of Trembler Oil Co., 5,000 shares of California Standard Gold Mines Corporation, and 9,000 shares of Salt Dome Oil Corporation.

<sup>453</sup> Id., at 1128-30 and Commission's Exhibit No. 103.



As a result, the uncertified check of Northern Fiscal Corporation, Ltd., for the amount of \$131,000 became part of the assets of Bond and Share Trading Corporation. In substance, therefore, Messrs. Erwin and Gutekunst received for their block of Bond and Share Trading Corporation Class A common stock and Class B common stock one-half of the portfolio securities in kind of the Bond and Share Trading Corporation, the investment company which they had sponsored, managed, and controlled.

At the same time the new board of directors of Bond and Share Trading Corporation authorized the purchase of 1,750 shares of the preferred stock of Northern Fiscal Corporation, Ltd. from Insuranshares Corporation of Delaware for \$175,000.<sup>454</sup> To meet this payment, Bond and Share Trading Corporation turned over the same check for \$131,000 to Insuranshares Corporation of Delaware, together with a cash payment of \$44,000, which it derived by liquidating some of its portfolio securities. Thus Bond and Share Trading Corporation held the 1,750 shares of the preferred stock of Northern Fiscal Corporation, Ltd., and Insuranshares Corporation of Delaware again held the uncertified check of Northern Fiscal Corporation, Ltd. for \$131,000 and also \$44,000 in cash.

On the same date, January 8, 1938, Insuranshares Corporation of Delaware transmitted the \$175,000 to Northern Fiscal Corporation, Ltd., for the 36,000 shares of the Class A stock and 302,400 shares of the Class B stock of Bond and Share Trading Corporation which Insuranshares of Delaware acquired from Northern Fiscal Corporation, Ltd.<sup>455</sup> In this manner Northern Fiscal Corporation, Ltd. received its own uncertified check for \$131,000 and, in addition, \$44,000 in cash.

Northern Fiscal Corporation, Ltd. thus derived a profit of \$22,000 on the transactions, since \$153,500 had originally been paid to Mr. Gutekunst and his associates for the control block of stock of Bond and Share Trading Corporation.<sup>456</sup>

Moreover, the Northern Fiscal group, which controlled Insuranshares Corporation of Delaware, owning at this time the control block of stock of Bond and Share Trading Corporation, had acquired a second investment company without any expenditure of their own funds. This had been made possible in large measure through the vehicle of the uncertified check for \$131,000 issued by Northern Fiscal Corporation, Ltd., which never cleared through any bank, and which was ultimately returned to Northern Fiscal Corporation, Ltd. Mr.

<sup>454</sup> Id., Commission's Exhibit No. 52 and Commission's Exhibit No. 103.

<sup>455</sup> Id., Commission's Exhibit No. 52.

<sup>456</sup> See supra, pp. 450-1. Messrs. Mancuso and Davidson received \$5,000 as commissions for effecting the purchase of Bond and Share Trading Corporation. Mr. Mancuso testified (id., at 799-800) :

Q. Did you get the \$5,000 commission?

A. \* \* \* We asked for our commission and they told us—Morris told us to go to the offices of Insuranshares. We went there and there was a check given to us for the sum of \$5,000.

Q. Drawn by whom?

A. Well, now, there were two names—signatures appearing—

Q. Was it an Insuranshares check?

A. No, no; it was a Canadian bank check, that is my recollection.

Q. Go on.

A. My recollection is that it was signed by Morris and by Solomont.

Q. Do you remember the name of Northern Fiscal on the check?

A. I could not say with definiteness.

Gutekunst admitted, in view of this transaction, that he had erred in transferring control of Bond and Share Trading Corporation to the Northern Fiscal group. He testified:<sup>457</sup>

Q. I asked you, in view of the circumstances that developed at the closing, in view of the fact that the check was not certified, in view of the fact that three new men were introduced at the closing and were stated to be there only for the purpose of that one meeting, and in view of the fact that there was no further explanation given, although you asked for it, and in view of the fact that the controlling system that you purchased from them out of the portfolio of Bond and Share Trading Corporation, and in view of the fact that the check was a Canadian check made out by Insuranshares and endorsed by them to you, did you think you did right in going ahead with the transaction?

A. It seemed so at the time.

Q. Does it now?

A. Of course, with the information we have on hand now, of course it doesn't. It would seem quite the opposite.

Bond and Share Trading Corporation held, as a result of the transactions, 1,750 shares of the preferred stock of Northern Fiscal Corporation, Ltd. in place of liquid portfolio securities valued at \$175,000. This preferred stock of Northern Fiscal Corporation, Ltd., represented an interest in a company whose assets consisted practically only of a minority block of the common stock of Insuranshares Corporation of Delaware. The substantial part of the assets of Insuranshares Corporation of Delaware consisted of its holdings of the control block of stock of Bond and Share Trading Corporation and 3,250 shares of the preferred stock in Northern Fiscal Corporation, Ltd. It will be recalled that on June 15, 1938, Insuranshares Corporation of Delaware was placed in receivership.<sup>458</sup>

#### 4. ACQUISITION OF CONTROL OF BURCO, INC.

After the acquisition of control of Bond and Share Trading Corporation, the Northern Fiscal group in March 1938 directed their attention to the acquisition of control of Burco, Inc., an investment company of the general management type, organized by George H. Burr & Co. under the laws of Delaware on September 13, 1929.

The capitalization of Burco, Inc. consisted of \$3 cumulative preferred stock entitled upon liquidation to \$50 and a no par common stock which had the sole voting power.<sup>459</sup> In September 1929 75,000 shares of the preferred stock and 75,000 shares of the common stock were sold to the public, for proceeds to the investment company of \$4,500,000.<sup>460</sup> At the same time George H. Burr & Co., the sponsors of the company, purchased 1,000,000 shares of its common stock for \$1,000,000.<sup>461</sup>

<sup>457</sup> Id., at 1133.

<sup>458</sup> See note 432, *supra*.

<sup>459</sup> The preferred stock was entitled to one vote per share in the event of default in payment of four successive quarterly dividend payments. (Id., Commission's Exhibit No. 92, Pt. I [Exhibit A-1 at 3].)

<sup>460</sup> Id., Commission's Exhibit No. 92, Pt. I (Exhibit E).

<sup>461</sup> Ibid.

Between 1929 and 1938, Burco, Inc. had returned to its security holders by way of repurchases and dividends a total of \$3,207,393.<sup>462</sup> As at March 1, 1938, therefore, the net capital contributed to the company was approximately \$2,300,000. However, at that date the assets of the company had a market value of approximately \$1,250,000, so that the company during this period of its operations had suffered a realized and unrealized loss of approximately \$1,000,000.<sup>463</sup>

As at March 1, 1938, Burco, Inc., had outstanding 29,745 shares of preferred stock entitled on any liquidation of the company to \$50 per share or to an aggregate preference in assets before the common-stock holders of \$1,487,250. In addition, 94,405 shares of common stock were outstanding. The then \$1,250,000 market value of the assets of the company was insufficient to meet the amount to which the preferred stock was entitled on liquidation of the company—the preferred stock had an asset value of \$42 per share and therefore was “under water”—and the common stock had a minus asset value. Before the common stock of the company could acquire any asset value the assets of the company would have had to increase by approximately \$287,000.

At this time, Carroll E. Gray, Jr. owned 36,000 shares, or approximately 38% of the outstanding common stock of Burco, Inc.<sup>464</sup> He had acquired 6,000 shares in the open market for a total of \$18,000.<sup>465</sup> The balance of 30,000 shares he had purchased in 1932 from George H. Burr for a total of \$140,000.<sup>466</sup>

George H. Burr had been a partner in the investment banking firm of George H. Burr & Co. which had sponsored Burco, Inc. On January 1, 1933 this firm was dissolved and its good will was succeeded to by Burr & Company, Inc., a Delaware Corporation,<sup>467</sup> which was organized by Carroll E. Gray, Jr. in February 1933.<sup>468</sup> George H. Burr remained associated with this new firm of Burr & Company, Inc.<sup>469</sup>

Carroll E. Gray, Jr. became president and a director of Burco, Inc.<sup>470</sup> In March 1938, Mr. Gray and his associates<sup>471</sup> controlled the

<sup>462</sup> Id., Commission's Exhibit No. 64. However, the stockholders who had resold their shares to the company had suffered substantial losses. Mr. Carroll E. Gray, Jr., who became president of Burco, Inc., in 1933, testified (id., at 897-8) :

Q. That preferred stock, when it was retired had been repurchased at substantial discounts?

A. Yes; below its liquidating value.

Q. So, although part of the money was returned to the public in the form of repurchases of preferred stock, the public had taken a licking on that preferred stock because it may have been repurchased from persons who bought it at par originally and were having it bought back for them at less than par; is that so?

A. Yes; the stock was bought on the New York Curb Exchange.

<sup>463</sup> Id., at 850, and Commission's Exhibit No. 64.

<sup>464</sup> Id., at 859-60. In addition he held approximately 250 shares of the preferred stock of Burco, Inc. (Id., at 865.)

<sup>465</sup> Id., at 845, 891.

<sup>466</sup> Id., at 843, 845.

<sup>467</sup> Id., Commission's Exhibit No. 92, Part I at 3.

<sup>468</sup> Id., at 842.

<sup>469</sup> Ibid.

<sup>470</sup> Id., Commission's Exhibit No. 92, Pt. I.

<sup>471</sup> Two of the five directors of Burco, Inc., were associates of Mr. Gray—George H. Burr, of Burr & Company, Inc., and R. P. Buell, of the law firm of Graham, McMahan, Buell & Knox, attorneys for Burco, Inc., and Burr & Company. (Id., at 861.)

company,<sup>472</sup> despite the fact that Mr. Gray held only a minority stock interest in Burco, Inc.

In January 1938, when the Northern Fiscal group commenced negotiations with Mr. Gray for the acquisition of control of Burco, Inc.,<sup>473</sup> the market value of the assets of the company was "a little under a million dollars." Thus there were not sufficient assets available to cover the preferential value of the preferred stock<sup>474</sup> and the common stock had a minus asset value. As a consequence, all of the assets of the company at this time, in theory, at least, "belonged" to the preferred stockholders of Burco, Inc. Had Burco, Inc. been liquidated at that time, the preferred stockholders would have received all of the company's assets and the 36,000 shares of the common stock of Burco, Inc. held by Mr. Gray would have received no part of the assets.

Nevertheless, despite the fact that the common stock held by Mr. Gray then represented no ownership interest in any of the assets of Burco, Inc., his possession of the largest single block of the common stock gave him the power to prevent the preferred stockholders from liquidating the company and obtaining their aliquot interest in the assets of the company; and enabled Mr. Gray to transfer the control of the funds, which substantially "belonged" to the preferred stockholders, to others without the prior knowledge or consent of these senior security holders. As had been indicated, the preferred stockholders, since they had no voting power at that time, were powerless to reach their assets by dissolving the company.<sup>475</sup> This power resided solely in the common stock in which, as has been stated, Mr. Gray had the largest single interest. Moreover, Mr. Gray and the other common stock holders who, because of their voting power, controlled the management of the company had been enabled to "speculate,"<sup>476</sup> as is the case of every investment company with senior securities, with the

<sup>472</sup> Id., at 880.

<sup>473</sup> Id., at 859.

<sup>474</sup> See supra for analysis of value of preferred stock on liquidation when the market value of the assets of the company was \$1,250,000.

<sup>475</sup> Even if the preferred stockholders had possessed the power to vote they would have been unable to compel a dissolution of their company. The Delaware Corporation law, under which Burco, Inc., was incorporated, required the consent of the holders of two-thirds of the voting stock to a dissolution of a corporation. (Del. Rev. Code, 1915, ch. 65, Sec. 39.) In January 1938 there were outstanding 29,745 shares of the preferred stock and 94,405 shares of the common stock of Burco, Inc. Since the common stock had no asset value, it would seem improbable that any large number of the holders of such stock would have consented to a dissolution of the company.

<sup>476</sup> Mr. Gray testified as follows with respect to the investment policy pursued by him in the management of the company's assets (op. cit. supra, note 1, at 870):

Q. You had operated that trust generally as a diversified management company, is not that so?

A. It had been operated as a trade corporation.

Q. You did not go into what we call special situations, did you?

A. Very seldom.

Q. You had marketable securities, and by trading corporation you mean, as counter-distinguished possibly from long-term investment, you were interested in trading profits as counter-distinguished from the long pull?

A. The policy of the corporation was to operate in trading profits, constant swings in the portfolio.

Q. That, of course, entailed having listed securities, is not that so, or securities with a fairly active—

A. Securities that could be bought or sold.

Q. Securities—

A. Yes; over-the-counter securities or listed securities.

Q. It involves over-the-counter securities which had pretty active over-the-counter market?

A. In most instances, yes.

funds contributed to the enterprise by the preferred stockholders without accountability to them for losses. In essence, the common stockholders had been empowered to operate Burco, Inc. as a "margin account," the "margin" being supplied by the funds of the preferred stockholders. Mr. Gray, when examined on this aspect of the capital structure of Burco, Inc., testified:<sup>477</sup>

Q. When you sat there with the common stock and the public was in the preferred stock and the balance of the common—I am just addressing myself to the preferred stockholders, I just want to find out what a preferred stock really is, aside from its theoretical attributes—the effect of that is that you were speculating with the public's money. Is that not so?

A. In what manner?

Q. Well, in this manner: When you come to analyze what the preferred stock really is and try to analogize to a margin account, the preferred stock is really in the position of a broker [in] that he is putting up the fund with which the common-stock holder speculates; is not that so?

A. That is so in any business.

Q. I am not unmindful of that.

A. Your premise is correct.

Q. That is right, so that capital structure which has senior securities in it is nothing more nor less than a margin account for the common stockholders; is not that so?

A. No; I would not put it in those terms.

Q. Well, you are not squeamish about the term "margin account"? They are even recognized by Regulation T, Mr. Gray.

A. I will say that the preferred stockholder put his money in any corporation with the knowledge that the common stockholder is going to manage the corporation.

Q. Well, no; but I am not talking about managing the corporation. The preferred stockholder puts up the money; is not that so?

A. Correct.

Q. He has got a ceiling on what his return can be, he cannot get more than \$50 on liquidation, no matter what the assets of the company are.

A. That is correct.

Q. He cannot get more than a fixed percentage of the income, is not that so?

A. That is correct.

Q. That is similar to a broker putting up margin for an account of his. The only thing he can get is his money back.

A. Yes.

Q. And his interest on the amount of money he loans to the customer, is not that so?

A. Yes.

Q. So the money contributed by the preferred stockholder in that respect, I say, was like the margin supplied by a brokerage firm to a fellow who is going to trade in common stock, is not that so? That is what you were doing?

A. No; I do not think so. You are drawing an analogy between floating capital and fixed capital.

Q. Well, if anything, the analogy is stronger because if that was a margin account when your account was under water, you would have gotten a telephone call to put up more margin.

A. That is correct.

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<sup>477</sup> Id., at 877-9.

Q. But in this case you did not even have to put up more money even though preferred stock was under water; is that so?

A. Correct.

Q. So, if anything, this analogy was stronger. You were speculating, and I am not being critical of that, just analyzing what the situation is in an investment trust that has senior securities. The fact of the matter is that you had better than a margin account because there was no broker to call you on the phone to say, "Mr. Gray, you are under water, put up more money."

A. Correct.

The preferred stockholders of Burco, Inc. may have purchased their securities to obtain a preference in the company's earnings and in its assets upon its dissolution. However, at the time when the preferential rights of the preferred stockholders became of importance—that is, after the company had sustained such losses as to make its assets insufficient to meet the liquidating preference of the preferred stockholders who were then the substantial "owners" of all the assets—the preferred stockholders were powerless to realize such preferences. At this point the common stockholders whose shares were without asset value and who had the sole power to dissolve the company had a pecuniary interest in preserving the existence of the company possibly adverse to that of the preferred stockholders. Mr. Gray, when examined with reference to the illusory nature of the preferential rights of the preferred stockholders of Burco, Inc., testified as follows:<sup>478</sup>

Q. You know sometimes I wonder what a bond or preferred stock means in the investment trust industry. Usually the justification for the issuance or rationale or *raison d'être* for a bond or preferred stock is that the investor is interested primarily in the safety of his principal, and he just wants a moderate return. Is not that so? That is the underlying philosophy of a senior security. The investor does not want to gamble, does not want to subject his money to any risk. All he wants to be sure of is when the time comes when he can get his money back, that he is going to get it, and, therefore, he does not want a big cut in the profits. He is satisfied with a moderate return of 5% or 6%.

A. He wants his principal intact.

Q. His principal intact, that is the thing that is bothering him. He just wants a reasonable return. It is the fellow who has the common stock, who is willing to take the longer shot and speculate, and get the greatest appreciation, if there is going to be an appreciation. Is not that so?

A. Yes; correct.

Q. While the company is healthy, and there is no pathological condition, and there is enough money to cover the preferred stock, then of course, he does not have to be worried about his principal. Is not that so?

A. That is correct.

Q. The only time his preferential position means anything to him is when the company has not sufficient assets, or just enough to pay the preferred stock. When the company is going broke, or has not sufficient money, there his preference is supposed to mean something. Is not that so?

A. That, not alone, can be applied to the assets, because a great many preferred stocks rely to a great degree on earning power.

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<sup>478</sup> Id., at 871-6.

Q. On earning power. I assume that the sales point for selling preferred stock, or the thing that motivates people in buying preferred and other senior securities as counter distinguished from common stock, is, "This is my life earnings. I do not want to shoot crap with this. I want to make sure my principal comes back to me, and therefore I am willing to take a moderate rate." Is not that so?

A. Yes; as a result of earning power.

\* \* \* \*

Q. Of earning power?

A. Coupled with principal.

\* \* \* \*

Q. So, during the normal course of the history of the corporation or the investment trust, if they have enough money to cover the preferred, and have something for the common, then this preference does not mean anything. The only thing this preference means is, he is getting less income than the common-stock holders.

A. That is correct.

Q. The time that his preferred position is vital is when there is not enough money to pay common stockholders anything; the preferred stockholder becomes concerned then as to whether his preference is going to mean anything. Is not that so?

A. That is correct.

Q. That was the situation at the time you carried on the negotiations for the sale of your common stock. Is not that so?

A. Correct.

Q. The common stock theoretically, if there was a liquidation, had no value at all, and here was the fellow who had the preferred stock, who was sitting with his preferred stock, taking, shall I say, less income than the common stock? Had you been paying dividend on your common stock all along?

A. In 1936.

Q. \* \* \* I may be making less than the common stockholders, but when the judgment day comes and there is not enough money to pay the common stocks and preferred stocks, then at least I feel I am going to get my principal back; is not that so?

A. Correct.

\* \* \* \*

Q. If his preferred stock meant anything at all to him at any time, that is the time it meant something to him?

A. Not any more than any other time.

\* \* \* \*

Q. You do not deny that if at that time there was a liquidation he would get every dollar of the money?

A. That is correct.

Q. And the common stockholder would get nothing?

A. That is correct.

\* \* \* \*

Q. You do not deny, Mr. Gray, that if you decided that you thought the trust should be liquidated at that time that you, with your block of stock, would have had that trust liquidated and turned the assets over to the preferred?

A. I did not think it should be liquidated at that time or any other time.

Q. I am not saying that. I am just propounding a hypothetical question. Your block of stock would have played a material part in any attempt to liquidate. Is not that so?

A. That is correct.

Mr. Gray conceded in his testimony that as the president and a director of Burco, Inc. and as its principal common stockholder he "owed a duty" to protect the interests of the preferred stockholders of Burco, Inc.

In January 1938 Lansing MacVickar first approached Mr. Gray to determine whether he would sell his 36,000 shares of the common stock of Burco, Inc.<sup>479</sup> Although Mr. Gray refused to accept the offers of Mr. MacVickar at this time on the ground that he "was not dealing with principals, and, secondly, the price was not high enough,"<sup>480</sup> he testified<sup>481</sup> that he found no difficulty in selling his common stock in Burco, Inc., which carried with it virtual control of the company, whose assets "belonged" to the preferred stockholders.

Q. You had no feeling about selling your block of stock, no difficulty with that aspect, just a matter of price and whom you were dealing with?

A. Correct.

Subsequently, Mr. MacVickar represented that his principals in this transaction were Messrs. Morris and Robb.<sup>482</sup> Mr. Gray agreed to carry on negotiations with these persons, having determined that Messrs. Morris and Robb were Boston attorneys with "a good reputation" and that their associate Mr. Solomont was "counsel for Paine, Webber & Company."<sup>483</sup> On February 28, 1938, Mr. Gray contracted to sell to Mr. Robb his block of 36,000 shares of the common stock of Burco, Inc. for \$9 a share, or a total of \$340,000.<sup>484</sup> The purchase price exceeded the market value of the shares sold by approximately \$286,000.<sup>485</sup> The substantial disparity between the purchase price of this minority block of stock in Burco, Inc. and the asset value and the market value of such stock evidently did not impel Mr. Gray to investigate fully the course of action that Messrs. Robb, Morris, and Solomont intended to pursue with respect to the use of the assets of Burco, Inc. That Mr. Gray's suspicions were aroused may be evident from his following testimony:<sup>486</sup>

\* \* \* I then asked them what they wanted of the investment trust. They said they had varied interests in varied companies, that they felt inflation was coming, wished to underwrite securities and they had the funds available to buy this trust.

Nevertheless, Mr. Gray made no attempt to verify, by investigation, the financial resources of Messrs. Robb, Morris, and Solomont.<sup>487</sup> As has been stated, he relied primarily on their "good reputation" as Boston attorneys.

Although Mr. Gray was disposing only of a minority block of the common stock of Burco, Inc., he agreed, without consulting the majority common stockholders whose vote had elected the existing

<sup>479</sup> Id., at 851.

<sup>480</sup> Id., at 859.

<sup>481</sup> Ibid.

<sup>482</sup> Id., at 862.

<sup>483</sup> Id., at 863.

<sup>484</sup> Id., Commission's Exhibit No. 91.

<sup>485</sup> The market value of Burco, Inc. common stock was approximately \$1.50 per share. (Id., at 865.)

<sup>486</sup> Id., at 863.

<sup>487</sup> Id., at 863.



directors at their previous annual meeting,<sup>488</sup> to place Messrs. Robb, Morris, and Solomont in control of the company by delivering to them all of its offices and directorships. Mr. Gray testified:<sup>489</sup>

Q. Was it made a condition to the purchase of the stock from you that everybody on the board would get off?

A. Not in the contract.

Q. But that was the talk?

A. General understanding.

Q. And pursuant to that understanding that is what happened; is not that so?

A. That is correct. I might add provided the new directors were satisfactory to us.

Q. Well, let me ask you this: Suppose that you put Leonard and Shearer on and two days later Leonard and Shearer resigned and that put two other people on. There was nothing you could do about it?

A. Nothing on earth.

Q. Nothing on earth? That was a possibility, you knew that. Is not that so?

A. Always.

\* \* \* \* \*

Q. \* \* \* Now when does the annual meeting of Burco, Inc., take place?

A. Usually in either November or December. The fiscal year ends September 30th.

Q. Had the annual meeting already been held?

A. Prior to——

Q. Just a short time before.

A. Several months.

\* \* \* \* \*

Q. And those stockholders had voted for you and the rest of the directors?

A. Correct.

Q. Were satisfied to have you handle their money?

A. Correct.

Q. For another year, at least; is not that so?

A. Correct.

Q. \* \* \* The old Board could not be put out by the stockholders and a new Board put in except at an annual meeting, is not that so?

A. Unless directors resigned.

Q. Unless directors resigned and that "unless directors resigned," Mr. Gray, was to cover the contingency if a vacancy occurred through sickness or resignation, et cetera; is not that so?

A. Or unless they did not wish in their own disposition to resign.

Q. And do you honestly assert that it was really intended to cover a situation where the directors were going to bodily pass over control to somebody else, and the procedure just took the form of one resigning, electing a new one, and another resigning electing a new one?

A. I think that is a general practice.

<sup>488</sup> The general corporation law of Delaware permits directors to resign and to elect their successors between annual meetings of the stockholders (Del. Rev. Code, 1935, Ch. 65, Sec. 30). However, some courts have held that a contract by which minority stockholders agree to transfer to the purchasers of their stock control of the directorate or a participation in the management of the company whose shares are sold is unenforceable as against public policy. *Fennessy v. Ross*, 90 Hun. 298, 35 N. Y. Supp. 868 (1895); *id.*, 5 App. Div. 342, 39 N. Y. Supp. 323 (App. Div. 1st Dept. 1896); *cf. McClure v. Law*, 161 N. Y. 78, 55 N. E. 389 (1899).

<sup>489</sup> *Op. cit. supra*, note 1, at 886-8.

Q. That is a general practice. Is that what you thought the articles of incorporation or bylaws meant when they stated that if there was a vacancy, the Board could fill the vacancy; is that right?

A. I was guided by my attorneys in that action, as I was when I bought the stock originally.

In essence, Mr. Gray was transferring the funds of the preferred stockholders of Burco, Inc., to the control of the Northern Fiscal group. Despite his conceded fiduciary relationship to the preferred stockholders, Mr. Gray took no steps to inform them or the majority common stockholders of his intention to transfer control of their funds to others, nor did he inform these stockholders of the personnel of the new management. Mr. Gray testified that he considered such a procedure "utopian":<sup>490</sup>

Q. You made no public announcement before you did it?

A. None.

Q. You did not send out any letters to the preferred stockholders that you contemplated doing it?

A. No.

Q. You did not send out any notices to the other common stockholders that you contemplated doing it?

A. None.

\* \* \* \* \*

Q. Yet you felt you owed no duty, or that it would have been, shall I say, well, the new thing to do, to say "Mr. Preferred Stockholder, I managed your money. I hold the common stock. I have been trading in securities on your money. For reasons best known to myself I would like to turn over the management of this company to somebody else." What do you think about it?

A. I think it is utopian.

Q. You think it is utopian, and why? Because it is decent?

A. Can you cite a case, a similar case in corporate history?

Q. Well, by utopian you do not mean it was an impossibility. You mean it had never been done before to your knowledge?

A. Correct.

Q. \* \* \* It was not physically impossible for you to do it?

A. Not physically impossible.

Q. You mean the mores and ethics, in your analysis of corporate and investment trust finance, is such that it is utopian to tell the people whose money you are controlling that you contemplate turning over the control of their money to somebody else?

A. No; I did not say that. I said that when you purchase an interest in a company with cash and administer it to the best of your ability, it is perfectly proper that you should sell it.

Furthermore, although Mr. Gray was aware of the fact that the investment policies of Burco, Inc. could be easily changed by the new controlling interests,<sup>491</sup> he accepted only the oral assurances of Messrs. Robb, Morris, and Soloment that the company's existing policy of "in-and-out trading" in securities which had been inaugurated in

<sup>490</sup> Id., at 876, 881-2.

<sup>491</sup> The Certificate of Incorporation of Burco, Inc. contained no restrictions on the investments which the management might make. (Id., Commission's Exhibit No. 92, Part I, Exhibit A.)

1933 by Mr. Gray himself would be continued.<sup>492</sup> Mr. Gray did not condition the sale of his stock upon the maintenance of the company's existing investment policy. Nor did he insist on remaining as a director of the company in order to observe the investment activities of the new group for the protection of the company's preferred stockholders. Mr. Gray testified:<sup>493</sup>

Q. Let me ask you this question, Mr. Gray—an investment trust is a peculiar kind of corporation in this respect, is it not—it is cash, is it not?

A. Or the equivalent.

Q. Or the equivalent. It is not like a steel company, where you sell the fellow bricks and mortars and if he wanted to walk off with the plant he might have some difficulty, although listening to some of this testimony possibly not, I do not know. But from the very nature of an investment trust—its assets being liquid, either cash or marketable securities—the chances for embezzlement, larceny, or conversion are greater in that type of situation than it is with a steel company, is not that so?

A. That is correct.

Q. Another thing is the mobile nature of the business of an investment trust, the fellow in the steel business cannot over night make up his mind to go into the fish business: is not that so?

A. Correct.

Q. So that a stockholder in a steel company has some assurance, for a little while, at least, even if the control passes, that he is going to be in the steel business and not any other kind of business: is not that so?

A. Correct.

Q. That is not true of investment trust?

A. No.

Q. You can have marketable securities one day and the next day you find out you are in the oil business down in Venezuela?

A. Correct.

Q. You were conscious of all these things?

A. Certainly.

Q. Those attributes of an investment trust?

A. Certainly.

Q. Now, even not taking the extreme case, you can visualize situations, can you not, where persons might want to be interested in a trading corporation because they did not believe in long-term investments, but believed in quick profits, in-and-out trading?

A. That is correct.

Q. You could change the fundamental nature of that business over night by changing from a trading corporation to a diversified long-pull investment company?

A. That is correct.

Q. Now a person who bought the stock in reliance on that fact that he was buying into a trading corporation, if control was to pass, do you think any duty was owed to him to apprise him of that fact before the fundamental nature of the business of the investment trust was to be changed?

A. If you knew it, yes.

---

<sup>492</sup> Id., at 893-5. Prior to 1933, Mr. Gray testified, the "trust was run as an investing corporation that bought shares of stock in corporations and sat tight with very little trading". (Id., at 894.)

<sup>493</sup> Id., at 882-5.

Q. If you knew it; but you are also conscious of the fact that in connection with investment trusts \* \* \* there was no impediment at all to such a change, was there?

A. None; no.

\* \* \* \* \*

Q. Did you consider that that was a matter of consequence? You had run it as a trading corporation. People bought the securities in reliance that it was a trading corporation. Is not that so? They may have?

A. They may have; yes.

Q. And people may have retained their stock in reliance that they were still going to be in a trading corporation. Is not that so?

A. That is right.

Q. You would not say, Mr. Gray, that if you were going to change the fundamental nature of the investment trust that the stockholders should not be considered on that question?

A. They should be.

Q. However, when it came to the question of transferring the power to change the fundamental nature, then you say that is "utopian"? Is that right?

A. Correct.

Q. Now, did you get any written provision in the agreement to the effect that they would maintain the same policy, Mr. Gray?

A. No.

Q. One of the finest checks on whether the investment policy was to be continued would be to have somebody on the board of directors. Is not that so?

A. That is correct.

Q. Did you ask for somebody on the board?

A. I did not.

The closing date of the contract of the sale of Mr. Gray's stock to Messrs. Robb, Solomont, and Morris was fixed for March 3, 1938.<sup>494</sup> Prior to that date, Mr. Solomont had, as in the previous instances, arranged with Paine, Webber & Co. to have that firm advance the funds necessary to effect this transaction.<sup>495</sup> Paine, Webber & Co., however, was only willing to advance \$290,000 to be secured by a list of stocks submitted to it by Mr. Solomont.<sup>496</sup> The securities contained in the list were the portfolio securities of Burco, Inc.

The contract price for the control block of stock of Burco, Inc., however, was \$340,000. To make up the difference, Mr. Robb gave Paine, Webber & Co. a certified check for \$50,000 and that firm arranged to have the Guaranty Trust Company of New York issue a cashier's check for \$340,000,<sup>497</sup> payable either to S. Leo Solomont or to Graham, McMahon, Buell, and Knox, Mr. Gray's attorneys.<sup>498</sup>

Between March 1 and March 3, 1938, members of the Northern Fiscal group had checked the portfolio securities of Burco, Inc.,<sup>499</sup> which were held by Commercial Trust Company of New Jersey under

<sup>494</sup> Id., Commission's Exhibit No. 91.

<sup>495</sup> Id., at 372, 379-80.

<sup>496</sup> Id., at 379-80.

<sup>497</sup> Ibid. Paine, Webber & Co. drew its check for \$340,000 to the Guaranty Trust Company (Id., Commission's Exhibit No. 57) and then that bank drew a cashier's check made payable to Messrs. Solomont or Graham, McMahon, Buell, or Knox. (Id., Commission's Exhibit No. 58.) This check took the form of a cashier's check to comply with the condition in the sales contract. (Id., Commission's Exhibit No. 91.)

<sup>498</sup> Id., Commission's Exhibit No. 58.

<sup>499</sup> Id., at 868, 895.

a custodian agreement.<sup>500</sup> In order that these securities, which had been held in the name of Mr. Gray, might "be handled" by the new management, they were endorsed in blank.<sup>501</sup>

On March 3, 1938, the closing date of the contract, the Northern Fiscal group turned over the cashier's check for \$340,000 to Mr. Gray's attorneys and received the 36,000 shares of stock of Burco, Inc.<sup>502</sup> The old directors of Burco, Inc. thereupon resigned and their places were taken by nominees of the new management.<sup>503</sup>

<sup>500</sup> Id., at 868.

<sup>501</sup> Id., at 893.

<sup>502</sup> Id., at 869.

<sup>503</sup> The new directors consisted of Americus J. Leonard, John B. Shearer, and George A. Becker, associates of Howard Hansell (id., at 666, 677, 698, 732-3), Arthur Quint, and Ralph H. Robb, associates of Mr. Solomont (id., at 683). Messrs. Shearer and Leonard had been invited by Howard Hansell to be members of the board of Burco, Inc., a few days prior to the consummation of the restrictions for the purchase of the control block of stock of Burco, Inc. (id., at 670-1, 677, 733-4).

Mr. Leonard testified as follows with respect to the manner in which he was invited on the Board of Burco, Inc. (id., at 670-3):

Q. Who is the first one who spoke to you about it?

A. Hansell.

\* \* \* \* \*

Q. When was that?

A. He called me up on that morning and asked me if he met me at the Bankers Club would I buy him a lunch on Saturday, February 26th.

\* \* \* \* \*

Q. You sat down, I assume you had lunch, and then you started to talk, is that it?

A. Discussed some of the mining matters first.

Q. Then after you discussed the mining matters, the conversation veered around to Burco, Inc.?

A. Right.

Q. What did he say to you?

A. He said, "Three lawyer friends of mine in Boston," he named them, one of them was Paine, Webber's attorney, were buying control of Burco, Inc. Then I asked him what Burco was. He said they were forming a directorate and asked if I would be willing to go in there as a director and as president. I told him I was open-minded, wanted to know more about it, and he asked what I was doing later in the afternoon.

Q. Now, you say he mentioned the names of three lawyers, one of whom was the attorney for Paine, Webber?

A. Leo Solomont, Thomas Morris, Ralph Robb.

Q. Did you ask him where they were going to get the money to buy the controlling stock of Burco?

A. He made the statement they were buying it with their own money.

\* \* \* \* \*

Q. Just asking you whether you would be interested in becoming president of Burco after these three lawyers with their own money bought control of the corporation, is that it?

A. Right.

\* \* \* \* \*

Q. \* \* \* You said you never heard of Burco except that you possibly may have read its name in the newspapers?

A. That is right \* \* \*.

Mr. John B. Shearer testified as follows with respect to the manner in which he was invited to be a member of the Board of Burco, Inc. (id., at 733-5):

Q. Now, coming down to the Burco transaction, when is the first time you were contacted in connection with that corporation?

A. The Sunday, I think it was the 27th of March, if I remember—the 27th of February.

Q. 1938?

A. 1938.

Q. Who called you?

A. Originally, Mr. Naphen.

Q. Mr. Naphen?

A. Yes.

Q. What did he say to you?

A. He said that, "Howard Hansell, whom you know, would like to meet you and talk about becoming a director of Burco."

\* \* \* \* \*

Q. Did you ask him what Burco was?

A. He said it was an investment trust that a group of men in Boston were buying control of.

\* \* \* \* \*

Q. You met Mr. Hansell and what did he say to you and what did you say to him?

A. He said a group of men were figuring on buying control of the Burco company, which was a small investment trust, and that they were contemplating after they bought it making an investment in Delta Oil stock of which I had been a director.

These new directors immediately voted to purchase on behalf of Burco, Inc., in accordance with a preconceived plan,<sup>504</sup> 325,000 shares of Delta Oil Company, Ltd. common stock and 25,000 shares of Insuranshares Corporation of Delaware common stock from Howard F. Hansell, Jr. for \$750,000. Ralph H. Robb, the treasurer of Burco, Inc., was authorized to transfer to Mr. Hansell or his nominee portfolio securities of Burco, Inc. which were to be sold in order to realize the \$750,000 necessary to pay for the Delta Oil Company, Ltd. and Insuranshares Corporation of Delaware stocks. The unsold securities were to be returned to Burco, Inc.<sup>505</sup> Mr. Hansell executed an assignment of the securities to Messrs. Solomont and Robb.<sup>506</sup> The securities were thereupon removed from the vault of Burco, Inc. and turned over to Paine, Webber & Co. in the name of Ralph Robb and S. Leo Solomont, "Burco A/C."<sup>507</sup> Paine, Webber & Co. immediately liquidated a sufficient number of these securities to satisfy the advance of \$290,000 which it had made to the Northern Fiscal group and which had been used by that group to acquire control of Burco, Inc.<sup>508</sup> The unsold securities were subsequently returned by Paine, Webber & Co., not to Solomont and Robb, but to Burco, Inc., which turned them over to Howard F. Hansell, Jr., in satisfaction of the purchase price of the stock of Delta Oil Company, Ltd., and Insuranshares Corporation of Delaware.<sup>509</sup>

To sum up these transactions, the Northern Fiscal group borrowed \$290,000 from Paine, Webber & Co. which, with \$50,000 of their own funds, was paid over to Carroll E. Gray, Jr., in consideration of the sale by him of a minority block of the common stock of Burco, Inc., and his agreement to turn over control of the board of directors of Burco, Inc. to the Northern Fiscal group. The Northern Fiscal group

<sup>504</sup> Mr. Leonard testified (*id.*, at 687-8) :

Q. You said Hansell spoke to you on the 26th of February. We are now up to March 3rd. Had Mr. Hansell communicated with you in this interim?

\* \* \* \* \*

A. March 2nd. Robb made the statement that Hansell—Robb made the statement, "We are going to make the purchase of Delta Oil stock" and mentioned the amount, number of shares, number of shares of Insuranshares, total amount of \$750,000. This was the—

Q. This was the 2nd, before the deal was closed, that is, before the controlling stock in Burco had been acquired, Mr. Robb made the statement that "after we acquired control of Burco, Burco is going to buy Delta Oil and Insuranshares Corp. stock"; is that it?

A. I do not know whether he said after—"We are going to acquire this."

Q. "We are going to acquire it." The only time he could have acquired it is after he bought control?

A. Naturally.

Q. On March 2nd you were told, that is, before you assumed the presidency of Burco—

A. Right.

Q. You were told after the three lawyers acquired control of Burco, Inc., and after you became president, it was contemplated Burco was to buy a big block of Delta Oil stock and Insuranshares Corp. stock which would aggregate how many dollars?

A. \$750,000.

See also testimony of Mr. Shearer quoted in note 503, *supra*.

<sup>505</sup> *Id.*, Commission's Exhibits Nos. 81 and 82.

<sup>506</sup> *Id.*, Commission's Exhibit No. 55.

<sup>507</sup> *Id.*, Commission's Exhibit No. 59.

<sup>508</sup> *Id.*, Commission's Exhibit Nos. 59, 81, 82 (List A).

<sup>509</sup> Paine, Webber & Co. were slow in liquidating the portfolio securities of Burco, Inc., held in the joint account of Messrs. Solomont and Robb and had only liquidated securities valued at \$400,000. (*Id.*, at 708-12.) By March 15, 1938, there was approximately \$210,000 as part of the commitment of \$750,000 due Howard F. Hansell, Jr., from Burco, Inc. (*Id.*, at 718.) The new management accordingly arranged for the return of the balance of the securities in the Solomont and Robb account held by Paine, Webber & Co. to Burco, Inc. (*id.*, at 713-4), and on March 17 the board turned over a portion of these securities to satisfy the balance of the commitment due to Howard F. Hansell, Jr. (*id.*, at 718-20.)

then liquidated virtually the entire portfolio of securities of Burco, Inc. in order to (a) repay Paine, Webber & Co.'s advance of \$290,000, and (b) to purchase blocks of the common stock of Delta Oil Company, Ltd., and Insuranshares Corporation of Delaware from Howard F. Hansell, Jr., a member of the Northern Fiscal group.<sup>510</sup>

Thus the substantial portion of the funds used by the Northern Fiscal group to acquire control of Burco, Inc. had been derived from that company's own assets at the expense of its preferred stockholders. On the other hand, Carroll E. Gray, Jr., the principal common stockholder of Burco, Inc., had been paid \$290,000 of its assets, which in theory belonged to the preferred stockholders of Burco, Inc. for the transfer of his negative asset value common stock in that company to the Northern Fiscal group.

Further, the transaction effected a radical departure from the existing investment policy of Burco, Inc. In place of diversified marketable securities,<sup>511</sup> the substantial assets of the investment company, as a result of the acquisition of control of the company by the Northern Fiscal group, now consisted of its holdings of large blocks of the securities of Delta Oil Company, Ltd. and Insuranshares Corporation of Delaware, neither of which had any quoted market values, and were not listed on any securities exchange.<sup>512</sup>

The 25,000 shares of Insuranshares Corporation of Delaware acquired by Burco, Inc. represented substantially only an interest in 3,250 shares of the preferred stock of Northern Fiscal Corporation, Ltd., and a controlling block of the stock of Bond and Share Trading Corporation, the substantial assets of which consisted only of 1,750 shares of the preferred stock of Northern Fiscal Corporation, Ltd.<sup>513</sup> The principal assets of Northern Fiscal Corporation, Ltd. consisted of approximately 78,000 shares, or 28% of the common stock of Insuranshares Corporation of Delaware.<sup>514</sup>

The investment of Burco, Inc. in the 325,000 shares of the common stock of Delta Oil Company, Ltd. was also of doubtful value. Delta Oil Company, Ltd., had been organized on May 6, 1937, as an asphalt and oil company to operate certain properties in Venezuela, which Howard F. Hansell, Jr., and his associates had been acquiring since 1934.<sup>515</sup> The company had issued 1,000,006 shares of common stock and \$305,000 principal amount of debentures.<sup>516</sup> Howard F. Hansell, Jr. had received 325,000 shares of the common stock of this company: 225,000 shares in consideration for promotion services and \$15,000,<sup>517</sup> and 100,000 shares at \$1.90 per share but for which he had only paid at this

<sup>510</sup> In addition, the Northern Fiscal group paid the following commissions in connection with their acquisition of control of Burco, Inc.: Lansing McVickar received \$11,000; a Mr. Stone received \$2,500; Lorimer Davidson received \$6,800, and Thomas W. Morris received \$7,000. (Id., at 810.)

<sup>511</sup> Id., Commission's Exhibit No. 59.

<sup>512</sup> Id., at 758.

<sup>513</sup> See *supra*, p. 465.

<sup>514</sup> See *supra*, pp. 445 and 448.

<sup>515</sup> *Op. cit. supra*, note 1, at 1484-5.

<sup>516</sup> Id., at 1471-2.

<sup>517</sup> Id., at 1470.

time another \$15,000.<sup>518</sup> These 325,000 shares of common stock together with the remaining issued shares of common stock were held under an escrow agreement pending the completion of arrangements for further financing of Delta Oil Company, Ltd.<sup>519</sup> Delta Oil Company, Ltd. did not have any funds with which to commence operations at this time. Thus, the value of the common stock was doubtful. Huntington D. Sheldon, the president of Petroleum Corporation of America which owns \$180,000 principal amount of the debentures of Delta Oil Company, Ltd. testified with reference to the value of the debentures and common stock of Delta Oil Company, Ltd.:<sup>520</sup>

Q. I would like to get some idea, if it is possible, what the present worth of this Delta Oil common stock is. Can you give us any opinion on that aspect?

A. Dealing with intangibles as far as the future is concerned, it is an impossible thing to set any figure on.

Q. But with respect to that, the investment trust is frozen in that investment for a substantial period of time, in your opinion, is it not?

A. Unless somebody would buy the whole block from them.

\* \* \* \* \*

Q. You just cannot assume to undertake to appraise the block—value of that block of stock at this time?

A. I would not undertake to do that.

Q. What do you think of your debentures?

A. When you make a public report to your stockholders every year and you have a question in your mind about the value of an asset, it is after all prudent to set up a reserve, which is what we did.

\* \* \* \* \*

Q. You are setting your block up in your books on the basis that ultimately it may not be worth a nickel?

A. You could put that interpretation on it.

Q. That is the debentures which are of course ahead of the common stock, is not that so?

A. Correct.

On March 23, 1938 the board of directors of Burco, Inc. representing the Northern Fiscal group, voted to stop the payment of dividends on the preferred stock,<sup>521</sup> although prior to the sale of control of Burco, Inc. the company had never failed to pay dividends on the preferred stock.<sup>522</sup> On April 19, 1938 the New York Curb Exchange suspended dealings in the common and preferred stock of

<sup>518</sup> Id., at 1474.

<sup>519</sup> Id., at 1477. Mr. Napfen testified (id., at 1477):

Q. Now, that tie-up agreement was important because——

A. That is right, it is important because if you are going to do financing, no one will do public financing on a broad scale, to carry out a program which would mean a great deal of money without ascertaining how to do it and to what extent it was to be accomplished and what scale, you would certainly expect and we would expect to negotiate within a few weeks. As soon as these men got back from Venezuela, and they are now back, we are going to start to undertake a financing program in London, and certainly no one would do it if the stock wasn't tied up in an escrow agreement.

<sup>520</sup> Id., at 763-4.

<sup>521</sup> Id., Commission's Exhibits Nos. 81, 82.

<sup>522</sup> Id., at 850.



Burco, Inc.<sup>523</sup> On June 15, 1938, a receiver was appointed for Burco, Inc.<sup>524</sup>

### D. Loans by Paine, Webber & Co.

It is obvious from the foregoing recital of the activities of the Fiscal Management and Northern Fiscal groups that their acquisition of control of First Income Trading Corporation, Continental Securities Corporation, Corporate Administration, Inc., Reynolds Investing Company, Inc., Insuranshares Corporation of Delaware, Burco, Inc., and Bond and Share Trading Corporation could not have been accomplished without the initial financial assistance of other parties.

Merely for the purposes of clarity of presentation, this section contains a detailed discussion, in chronological sequence, of the various loans by Paine, Webber & Co. to these individuals, the circumstances under which these loans were made, and the effect of these loans upon the investment companies involved. This assistance was furnished by Paine, Webber & Co. to the groups in connection with the acquisition of control of First Income Trading Corporation, Continental Securities Corporation, Insuranshares Corporation of Delaware, and Burco, Inc.

Stephen Paine, a partner in the firm of Paine, Webber & Co., when examined on that phase of the activities of the groups, testified:<sup>525</sup>

Q. \* \* \* You do not deny now, Mr. Paine—and I am not trying to create any implication or any inference or anything at all—that all this activity, in connection with First Income Trading Corporation, Continental Securities Corporation, Insuranshares Corporation of Delaware, and Burco, Inc. could not have happened or transpired without the unconscious or conscious assistance of Paine, Webber & Company, isn't that so?

\* \* \* The only observation I am making is that hadn't you made the check available in the First Income Trading Corporation and in the Continental Securities Corporation and the Insuranshares Corporation of Delaware, and the Burco, Inc. transactions, these people, unless they got the check some place, could not have done what they did, isn't that so?

<sup>523</sup> The Curb in its announcement of the suspension stated that "due to the basic change in the nature of Burco, Inc., from a company having a wide diversification in investments to a company having as its major asset a minority interest in a single company, the Exchange has suspended dealings \* \* \* pending an examination by the Exchange of the Delta Oil Company, Ltd." (*The New York Times*, April 20, 1938, p. 33.)

<sup>524</sup> On June 15, 1938, a custodial or temporary receiver was appointed for Burco, Inc., on application of a stockholder to protect the company's assets against further depletion by the Northern Fiscal group. (*The New York Times*, June 16, 1938, p. 33.) On September 15, 1938, the Court denied a motion to dismiss the receiver and ordered that the receivership be maintained until the stockholders can elect "a proper and new board of directors." The Court, in this connection, further said: "It appears to me that some of them trusted 'not wisely, but too well,' with the result that the corporate defendant has suffered tremendous financial losses. Dishonesty and crookedness to an appalling extent characterizes the acts of the former directors who are now properly facing civil as well as criminal prosecution, and since the present board of directors owed their offices directly or indirectly by virtue of the favor of the 'looters' prudence dictates consideration of the stockholders' position in this unhappy situation". (*The New York Times*, September 16, 1938, p. 29.)

<sup>525</sup> Op. cit. supra, note 1, at 392-3.

A. This business would never have been done if we had not known Mr. Solomont. That is the only way I can answer that.

Q. But hadn't you drawn the checks to him?

A. Yes.

## 1. LOAN IN CONNECTION WITH ACQUISITION OF CONTROL OF FIRST INCOME TRADING CORPORATION

The first loan made by Paine, Webber & Co. was in connection with the acquisition of control of First Income Trading Corporation. On August 5, 1937, as has already been stated, S. Leo Solomont requested Paine, Webber & Co. to advance \$110,000 to be secured by securities, a list of which was shown to that firm on that date. At this time Stephen Paine, a partner of Paine, Webber & Co., was in Europe and the negotiations were carried on between Mr. Solomont and John L. Gately, the credit manager of the Boston office of Paine, Webber & Co. Mr. Gately testified as follows with respect to the proposition presented to him on that day by Mr. Solomont.<sup>526</sup>

Q. Let me ask you this, Mr. Gately, precisely what was the nature of the transaction? Did he say he wanted to make a loan on these securities or that he wanted to sell these securities, and that they wanted a check in advance?

A. That is what happened.

Q. Which one? I have given you two alternatives.

A. They were to pay \$110,00 that day for that list of securities.

Q. For that list of securities?

A. Yes.

Q. That is, you were to give them \$110,000 in advance, and the securities were to be subsequently sold, and any excess over that \$110,000 after deducting your commission and fees was to be turned over to the client or Mr. Solomont, is that correct?

A. That is correct.

In other words, therefore, the plan as presented to Mr. Gately by Mr. Solomont was that Paine, Webber & Co. was to advance \$110,000 prior even to the receipt of the securities which were to constitute the collateral for this advance and prior to the sale of these securities in satisfaction of the advance. Mr. Gately conceded that this procedure was not in accord with normal brokerage practice:<sup>527</sup>

Q. Ordinarily you do not do that, do you? You only make payment after the two-day delivery period, isn't that so?

A. Ordinarily, but it is something that can be done.

Q. You mean there is no law against it?

A. There is no law against it.

Q. But in the usual procedure, particularly involving such a substantial amount, you sell the securities and wait the two-day delivery period and get the money, and then you turn over the check?

A. That is the ordinary procedure, sir.

Q. But in this case, did he have the securities with him?

A. No, sir.

Q. They were out in Detroit, he told you?

A. They were in Detroit, Michigan.

<sup>526</sup> Id., at 173.

<sup>527</sup> Id., at 173-5.

Q. But he wanted a check for \$110,000 that day?

A. Yes.

Q. And were you going to sell the securities that day or the following day?

A. Well, we were going to sell the securities as soon as we were satisfied that they had been received and the money had been paid. the \$110,000 had been paid.

Q. When were you going to put in the order to sell these securities?

A. As soon as the securities were received.

Q. So that it is possible that on August 5th after you had turned over the check for \$110,000 you would have sold the securities that day, or you would have to wait and sell them the next day?

A. We could not sell them that day because the market was closed when we got advice that the securities had been received.

Q. But you had turned over your check for \$110,000 by that time.

A. Well, I was advised by our Detroit office that that is what took place.

Q. So the fact was that the check for \$110,000 was turned over before even the order for the sale of those securities was given by your office?

A. My orders to actually sell them?

Q. Yes.

A. Correct.

Mr. Solomont, prior to this time had only a small brokerage account with Paine, Webber & Co.<sup>528</sup> and had never been a "big trader"<sup>529</sup> nor brought in any large amounts to Paine, Webber & Co., Mr. Gately testified:<sup>530</sup>

Q. So that up to August 4th or 5th, Mr. Solomont was a negligible investor or trader, as far as Paine, Webber were concerned?

A. That is correct, sir.

Q. And he had never before that time asked Paine, Webber to make a substantial loan on securities for any client, isn't that so?

A. Correct.

Q. Did he ever ask them to make a loan of any size on any securities for anybody prior to that time?

A. Not to my knowledge.

Q. So that on August 4th or 5th when Mr. Solomont came to you for the first time, that was a new experience for you with respect to Solomont, isn't that so?

A. That is correct.

Q. At that time he did not come to you as a lawyer; he came representing a client and tried to get a loan from Paine, Webber & Company, although he was the lawyer for Paine, Webber & Company at that time?

A. Well, I viewed his coming in the capacity of our lawyer——

Q. He also represented, ostensibly, somebody who wanted a substantial loan, isn't that so?

A. A client of his.

\* \* \* \* \*

Q. You said he said he had a client. Did he say who the client was?

A. He didn't say at that time.

Q. Did you ask him?

A. No, sir.

<sup>528</sup> See note 18, supra.

<sup>529</sup> See testimony quoted following.

<sup>530</sup> Op. cit. supra, note 1, at 168-9, 171.

Q. Did he tell you what the amount of the loan was?

A. I think he said \$110,000.

Q. That was a very substantial loan, wasn't it?

A. Yes, sir.

Q. Did you ask him whether it was an individual or a corporation?

A. No, sir.

Q. Did you ask him whether it was an investment trust, an insurance company, or——

A. No, sir. I didn't ask him anything.

Q. And you say he just exhibited a list of securities to you?

A. Which he said belonged to a client.

Mr. Gately made no investigation of Mr. Solomont's client, on behalf of whom Paine, Webber & Co. had agreed to make the advance. On August 5, 1937, prior to the closing of the contract for the acquisition of control of First Income Trading Corporation by the Fiscal Management group, Mr. Solomont informed Mr. Gately that Mr. Clayton was his client,<sup>531</sup> but Mr. Solomont requested Mr. Gately to confirm the transaction with Mr. Morris.<sup>532</sup> However, when Mr. Gately called Mr. Morris, he was referred by Mr. Morris to Mr. Clayton and the latter discussed the final arrangements with Mr. Gately.<sup>533</sup> Mr. Gately, however, was not suspicious about the particular relationship of either of these persons to the transaction, although prior hereto he had never heard of either Mr. Clayton or Mr. Morris. Mr. Gately testified:<sup>534</sup>

Q. Now, he didn't have the securities with him. When he said they were in Detroit, what did you do?

A. Then he came back later in the day, and I should judge it was somewhere between 12:30 and 1:30, somewhere in there, in that vicinity, and he said, "I think we can put through that deal." He said, "Will you call Mr. Morris, he is at the Cadillac Hotel in Detroit." I did and Mr. Morris answered the phone——

Q. Who is Mr. Morris?

A. I don't know, sir.

Q. Had you ever heard of Mr. Morris in your life, prior to that time?

A. Prior to that, no, sir.

Q. Did you ask Mr. Solomont why you had to call Mr. Morris; did he say Morris was the client?

A. No, sir.

Q. Did you call Mr. Morris, or did you call Mr. Clayton in Detroit, at that time?

A. If I may correct a little there, in this way; I think I did. I called Mr. Clayton.

\* \* \* \* \*

A. I believe I called Mr. Clayton at Detroit—now, wait a minute. You asked me if I called Mr. Morris. I called Mr. Morris and then Mr. Clayton came on the phone, and he said "Well—" Mr. Clayton said, "I will talk to you about the arrangements"——

Q. Why did Mr. Solomont ask you to call Mr. Morris or Mr. Clayton?

A. Because as it turned out Mr. Clayton was the client.

<sup>531</sup> Id., at 176.

<sup>532</sup> Ibid.

<sup>533</sup> Ibid.

<sup>534</sup> Id., at 176-7.

Q. Did he tell you at that time Mr. Clayton was his client?

A. I asked him in the morning when he came in who his client was.

Q. Had you ever talked with Mr. Clayton before in your life?

A. No, sir; I never heard of him or saw him.

Thereafter, at the closing of the contract, Raymond W. Moitell of the Detroit offices of Paine, Webber & Co. turned over to George H. Clayton, Jr. a check for \$110,000 drawn to his order by that firm. Mr. Moitell received in return, not securities owned by George H. Clayton, Jr., but securities which belonged to First Income Trading Corporation, without any formal authorization of that investment company opening an account with Paine, Webber & Co. Mr. Moitell testified: <sup>535</sup>

Q. Did you have any certificate showing that the First Income Trading Corporation, at the time when you took over the First Income Trading Corporation securities was opening an account with you, Paine, Webber & Co.?

A. Not at that time.

Q. Did you have such a resolution designating who were the two officers who could sell or transfer the securities of First Income Trading Corporation at the time you took the securities and turned over the check to Clayton?

A. No.

Q. Did you see any at that time?

A. No.

The only document prepared on this day in connection with the transmittal of the securities was a letter addressed to Paine, Webber & Co. by George J. Mitchell, Jr., <sup>536</sup> one of the group as the new president of First Income Trading Corporation, transmitting a list of portfolio securities of First Income Trading Corporation, and authorizing Paine, Webber & Co. to "issue a check in the amount of \$110,000 to the order of Mr. George Clayton." Although Mr. Moitell knew that Mr. Grow had been president of First Income Trading Corporation, he made no inquiry with respect to the change in the management when he saw Mr. Mitchell's signature as president of First Income Trading Corporation. Mr. Moitell testified: <sup>537</sup>

Q. You never heard of Mitchell before that time, had you?

A. No, I hadn't.

Q. Didn't you ask Mr. Grow who Mr. Mitchell was?

A. He had been introduced.

Q. As what?

A. He had been introduced to me when they all came into the office.

Q. Introduced as what?

A. No particular title.

Q. You knew Mr. Grow had been president of the First Income Trading Corporation, didn't you?

A. He had been, I knew that.

Q. And didn't they apprise you of the fact that the First Income Trading Corporation was selling the stock and the money was being turned over to George Clayton?

A. No, they didn't.

\* \* \* \* \*

<sup>535</sup> Id., at 190.

<sup>536</sup> Id., Commission's Exhibit No. 11.

<sup>537</sup> Id., at 192-3.

Q. Did you ask Mr. Grow whether he had severed his connection with the First Income Trading Corporation?

A. No, I did not.

It was not until September 1, 1937 that Paine, Webber & Co. requested First Income Trading Corporation to forward the necessary corporate authorization to establish a brokerage account with Paine, Webber & Co.,<sup>538</sup> and this authorization was not transmitted to Paine, Webber & Co. until September 10, 1937.<sup>539</sup> It will be recalled that prior to September 10, 1937 the new officers of First Income Trading Corporation designated by the Fiscal Management group, had been directing Paine, Webber & Co. with respect to the liquidation of the portfolio securities in the account of First Income Trading Corporation which had been opened with that brokerage firm.

Stephen Paine, upon his return from Europe in the latter part of August 1937, was informed by Mr. Gately about the transaction and was presented with the papers relating to the First Income Trading Corporation transaction. Mr. Paine evidenced no interest in the transaction although Mr. Solomont had never been "a big trader" and had never, prior to this transaction, "brought in any big accounts" to Paine, Webber & Co. Mr. Paine testified:<sup>540</sup>

Q. And did anybody mention to you this piece of business that Mr. Solomont had brought in?

A. Not for a few days, no, sir.

Q. Can you approximate when is the first time you had knowledge or notice that Paine, Webber & Company had acted in the First Income Trading Corporation transaction in any capacity?

A. I knew nothing about that First Income Trading transaction and I learned of that in the latter part of August, that Mr. Solomont had been instrumental in getting us some commission business.

Q. Whom had you talked to?

A. Mr. Gately came and told me about it.

Q. And do you remember what Mr. Gately said to you?

A. That is all he said.

Q. He told you that Mr. Solomont had brought some commission business to you?

A. Some commission business to us, yes.

Q. You knew that Mr. Solomont had not been, as far as your firm was concerned, a heavy trader or big investor, isn't that so?

A. Yes, sir.

Q. By "yes, sir" you mean "No," is that it, he was not a big trader?

A. I knew that personally he was not a big trader.

Q. And you also knew prior to that time he had never brought in any big account?

A. He had steered a little bit of business our way occasionally.

Q. But not in figures running into \$150,000?

A. I don't believe so.

Q. Did you ask Mr. Gately what the name of the client was that he brought in?

A. No.

Q. Did you get any details at all with respect to that piece of business?

A. No.

\* \* \* \* \*

<sup>538</sup> Id., Commission's Exhibit No. 23.

<sup>539</sup> Id., Commission's Exhibit No. 24.

<sup>540</sup> Id., at 262-3, 266.

Q. So that up to March 15, 1938, as far as First Income Trading Corporation was concerned, you were living in blissful ignorance as to what transpired?

A. Well, we may have 75 brokerage accounts on the desk and it did not really mean very much.

Q. That is, it did not mean very much to you but you now see what it meant to the stockholders, don't you?

A. Yes, sir.

The documents which were turned over to Mr. Paine in connection with this transaction<sup>541</sup> included, among other things, a copy of the minutes of First Income Trading Corporation which disclosed that First Income Trading Corporation was authorized to purchase the preferred stocks of a Canadian company from George H. Clayton, Jr., and that in consideration therefor he was to receive the proceeds of portfolio securities of First Income Trading Corporation which were to be liquidated. Mr. Paine denied that he examined this document:<sup>542</sup>

Q. \* \* \* But the thing that was handed to you in the latter part of August, which is the resolution which was passed specifically [at the request of Paine, Webber & Company] on its face says, does it not, that the corporation is authorized to buy 120,000 shares of Canadian stock \* \* \*? It says you can sell these securities of First Income Trading Corporation and give George Clayton \$120,000. And in consideration for the transfer of the \$120,000 of preferred stock, he is to get that amount in cash in addition to (blank) dollars. Isn't it manifest to you now, Mr. Paine, that right on the face of the resolution which was handed to you in the latter part of August it was clear that they were selling the First Income Trading Corporation and giving \$120,000 to Clayton, and Clayton was going to use the \$120,000 to buy the Canadian stock?

A. Well, I would assume from this thing that Clayton had sold to the First Income Trading Corporation this Canadian stock, and they paid him——

Q. And he was reimbursing himself out of the sale of the stocks of the First Income Trading Corporation, isn't that so?

A. Well, that is what I think the result is; yes.

Q. Now, these papers are the acknowledgments and receipts by George Clayton that he got the \$110,000 check. \* \* \* It is evident at the present time that at that time they were selling portfolio securities of the investment trust and using the funds of the investment trust to buy the Canadian stock?

A. That is evidently the intent, but as I said, I did not know it at all then.

Q. That is because you did not read these documents?

A. That is right, because the transaction was closed.

In connection with the First Income Trading Corporation transaction Mr. Paine denied he paid any commission to Mr. Solomont.<sup>543</sup> Nevertheless, Mr. Paine conceded that from the proceeds of the portfolio securities of First Income Trading Corporation which were sold by Paine, Webber & Co., \$802.69<sup>544</sup> was deducted and credited to Mr. Solomont's personal brokerage account with Paine, Webber & Co. to clear his debit balance in that amount. However, Mr. Paine testified that he only discovered the fact on or about March 15, 1938.<sup>545</sup>

<sup>541</sup> Id., Commission's Exhibit No. 13.

<sup>542</sup> Id., at 269-70.

<sup>543</sup> Id., at 1675.

<sup>544</sup> Id., at 1677-8.

<sup>545</sup> Id., at 1679.

## 2. LOAN IN CONNECTION WITH FIRST ATTEMPT OF FISCAL MANAGEMENT GROUP TO ACQUIRE CONTROL OF INSURANSHARES CORPORATION OF DELAWARE

In September 1937, a month after Paine, Webber & Co. had advanced \$110,000 to George H. Clayton, Jr. at the request of Mr. Solomont, in connection with the acquisition of control of First Income Trading Corporation, Mr. Solomont approached Stephen Paine and requested an advance of approximately \$350,000, to be secured by portfolio securities of Insuranshares Corporation of Delaware. Paine, Webber & Co. was to liquidate these portfolio securities and deduct from the proceeds the amount of this advance, remitting any balance to Insuranshares Corporation of Delaware. Mr. Paine testified as follows with respect to the proposition presented to him by Mr. Solomont:<sup>546</sup>

Q. When is the next time, subsequent to First Income Trading Corporation transaction, that Mr. Solomont came to you in connection with any transactions of a nature similar to the First Income Trading Corporation deal, whether they were successfully consummated or not, do you recall?

A. Yes; I think I do. I think about the latter part of September, Mr. Solomont came to me and said that there is a concern by the name of Insuranshares Corporation that has a large block of New England Fund which they had had for a little while and they were unhappy with and "I am working on a plan with the Insuranshares people, to dispose of that particular investment."

The value of it then was \$320,000. He said that the Insuranshares Corporation was considering a change in some of their portfolios and it involved a vote of that particular stock and a few hundred shares of some other stock to a total amount of \$350,000 and he wanted to know if we would like the brokerage account in connection with liquidating the New England Fund and other securities.

I said, "What do you mean by that?" He said, "I would like to pick up a loan on it for \$40,000 or \$50,000 and you will liquidate the New England Fund and some of the other securities." I said, "As far as I know that sounds all right, as our attorney would you advise that transaction?" And he said, "Yes," so on the first or second of October he called me up and said that the transaction did not go through.

Mr. Paine made no inquiry about Mr. Solomont's precise interest in the transaction, although he knew that Mr. Solomont had never previously represented any investment company.

Mr. Paine further testified:<sup>547</sup>

Q. Did he say he was the attorney for Insuranshares Corporation of Delaware?

A. No, sir.

Q. Whom did he say he represented in that picture?

A. He said he represented Paine, Webber & Company, but he knew the Insuranshares people and a brother attorney of his, a friend, also knew the Insuranshares people.

Q. When I say represented, I don't mean in the legal sense, but was he working for the Insuranshares of Delaware?

A. He simply was asking me if we were interested in doing that particular piece of brokerage business with the Insuranshares people.

<sup>546</sup> Id., at 272-3.

<sup>547</sup> Id., at 273-4.



Q. As far as you knew, prior to the time that you came back from Europe, Solomont had never represented any investment trust; isn't that so?

A. That is right.

Q. He had not?

A. He had not.

Q. You knew that Insuranshares Corporation of Delaware was an investment trust, did you not?

A. I knew that Insuranshares was an investment trust; yes, sir; as such, it was not a very good one. I think it was rather unhappy about this whole situation.

Q. Maybe it was not so unhappy until the time we will talk about this morning. Did he tell you in what capacity he was acting, Mr. Paine; had he gone into the brokerage business? He was not their lawyer. Did he say he was going to get you the account if you handled this deal? Did you ask him what his connection with Insuranshares was?

A. No; I did not. He simply said he has a friend who was interested in the Insuranshares, and he wanted to know if we would do some brokerage business for them.

Mr. Solomont's negotiation with Paine, Webber & Co. in connection with the transaction relating to Insuranshares Corporation of Delaware had progressed to a point where Mr. Paine had directed the drawing of three checks totaling \$310,000 payable to the order of Mr. Solomont<sup>548</sup> to be delivered to him in consideration for the receipt from Insuranshares Corporation of Delaware<sup>549</sup> of the portfolio securities, including the certificates in New England Fund. Although Mr. Paine admitted that it was not the customary procedure for investment companies to liquidate portfolio securities and use the check issued by a brokerage house to buy other securities without clearing the check through the investment company's bank account, he did not question the procedure in this case. Mr. Paine testified:<sup>550</sup>

Q. Of course, if what Mr. Solomont told you was so—that Insuranshares Corporation of Delaware just wanted to realize on this New England Fund shares—there would be no necessity, would there, for issuing these checks?

A. Well, I would not know whether they were going to buy these blocks of stock in one place or another. It is quite possible for them to sell \$320,000 of their New England Fund and go into three or four—

Q. But the way that would be handled would be they would deposit the check and issue their checks against that deposit; isn't that so?

A. That would be one way.

Q. You never heard of people taking a check from Paine, Webber and using that check to buy other securities, did you?

A. It is not the usual practice; no, sir.

Q. If that is what they intended to do, you would suspect that it would obviously be phony; isn't that so? No investment trust would take proceeds from the sale of securities and not deposit the check that they received for those securities and buy other securities without clearing it through the bank; isn't that so?

A. That is right.

Furthermore, New England Fund was an open-end investment trust which was required to redeem its own securities for cash at their

<sup>548</sup> Id., at 276.

<sup>549</sup> Id., at 277.

<sup>550</sup> Ibid.

approximate asset value. In other words, Insuranshares Corporation of Delaware could have obtained in cash the asset value of its New England Fund certificates merely by presenting them to that company for redemption, and consequently there was no necessity for the intervention of a brokerage firm to liquidate these certificates.

### 3. LOAN IN CONNECTION WITH ACQUISITION OF CONTROL OF CONTINENTAL SECURITIES CORPORATION

On October 23, 1937, a month after Mr. Solomont had directly approached Mr. Paine in connection with the advance on the portfolio securities of Insuranshares Corporation of Delaware, Mr. Solomont again requested Mr. Paine to have his firm advance \$580,000 to a client of Messrs. Morris and Robb, Boston attorneys, to be secured by another list of portfolio securities shown to Mr. Paine. Mr. Paine, when examined with respect to this advance, testified: <sup>551</sup>

Q. Yes, tell us in the greatest detail what he said to you and what you said to him.

A. Well, he came to me, I think it was the 23rd of October, and said that a client of Messrs. Morris and Robb wanted to borrow some money on a certain line of securities and he exhibited to me a list and I said, "Well, this is a long list; can I have it and figure the thing out?" He said, "You can make a copy of it; this is the only one I have." I said, "How much do you want to borrow?" and he said about \$580,000. I said, "That is a fairly large loan, what sort of a transaction is it, who is it for?" and he said, "I don't know anything about it. All I know is that this client of Morris & Robb wants to make this transaction." I said, "I will figure out and see what we can do, whether we can do it or not."

Although the list of securities presented to Mr. Paine, on which he was requested to make the advance, indicated that "a large account" of diversified securities peculiar to either an insurance company or an investment trust was involved, Mr. Paine made no inquiries respecting the "client" of Messrs. Morris and Robb. Mr. Paine testified that, in fact, he "did not pay much attention to it [the list]": <sup>552</sup>

Q. When he submitted this list to you, did he tell you the client was an individual or an investment trust, or who had those securities?

A. He did not say.

Q. Now look at that list which is four pages long. You did not even remotely assume that this belonged to some individual, did you, Mr. Paine?

A. Frankly, I didn't know what it was. I knew it was a list of securities that were then being presented to us, and we often have presented to us lists larger than this for analysis, suggestions, for substitution, and so forth.

Q. That is all right, but here is an individual coming to you who says "Here is the list. I want a loan of \$580,000." You do not think any individual had the diversified portfolio running from Allied Chemical on down to West Pennsylvania 7 Preference A, did you?

A. Frankly, I did not pay much attention to that.

Q. Wasn't it obvious to you at that time that this particular list of securities was the portfolio at least of some institution, either an insurance company or an investment trust, or some other similar institution?

A. Frankly, I thought of it as a large account, that is all.

<sup>551</sup> Id., at 279.

<sup>552</sup> Id., at 281-2.

Q. A large account, about 25 securities to the page in varying blocks of 200, 200, 300, 200, and you had no suspicions that that was the portfolio of an investment trust or an insurance company or some institution?

A. I may have thought that it was part of it, but I had no suspicions that it was all of it.

Q. Well, this is a typical orthodox portfolio of diversified securities of an investment trust, isn't it, Mr. Paine?

A. Well, it may be the portfolio of an individual. As I say, we have countless lists of this sort submitted to us for analysis.

Mr. Paine, on the same day (October 23, 1937), after determining that the value of the securities on the list exhibited to Paine, Webber & Co. was \$2,549,380,<sup>553</sup> agreed to make the advance, provided that Mr. Solomont approved "of a transaction of this sort" and would "handle the legal end."<sup>554</sup> Thus, although Mr. Paine had, as previously indicated, evidenced no suspicions because of the size of the security list, he did at this point request Mr. Solomont's approval because "it is a large list of securities and we wanted to let somebody know what it was all about," apparently aware that this was not an "ordinary garden variety of pick-up."<sup>555</sup>

On October 25, 1937, Mr. Solomont telephoned Mr. Paine from New York and informed him that "the loan was all ready to be picked up," that "the certificates would be in street form." Mr. Solomont further requested that the Paine, Webber & Co. check be made payable to S. Leo Solomont and be certified so that he could "make the check over to whoever the proper party was"<sup>556</sup> and "have somebody go over to Jersey City with him [Solomont] to bring back the securities."<sup>557</sup> At the same time, Mr. Solomont informed Mr. Paine that "it is a straight loan, as far as I can tell you. I think it is a transaction with Alexander Beverly."<sup>558</sup> Although Mr. Paine was then aware that Mr. Beverly was the ostensible client of Messrs. Morris and Robb, he complied with Mr. Solomont's instruction that the firm's check in the sum of \$580,000 be made payable to the order of Mr. Solomont on the ground, as Mr. Paine stated, "that he [Solomont] did not know to whom it ultimately was going."<sup>559</sup> Furthermore, Mr. Paine made no attempt to check the financial responsibility of Mr. Beverly prior to delivering his firm's check for \$580,000 to Mr. Solomont.<sup>560</sup> However, on October 26, 1937, the day after the delivery of the check, Mr. Paine made an investigation of the financial responsibility of Mr. Beverly and ascertained that "he is well regarded and is [a] party of some means."<sup>561</sup> The mechanics of this transaction did not arouse any suspicion on the part of Mr. Paine although they were similar in character to the transaction Mr. Solomont had previously presented to Mr. Paine in connection with Insuranshares Corporation of Delaware. Mr. Paine testified:<sup>562</sup>

<sup>553</sup> Id., at 283.

<sup>554</sup> Ibid.

<sup>555</sup> Id., at 284.

<sup>556</sup> Id., at 285.

<sup>557</sup> Ibid.

<sup>558</sup> Id., at 286.

<sup>559</sup> Id., at 290-1.

<sup>560</sup> Id., at 286 and Commission's Exhibit No. 30.

<sup>561</sup> Id., Commission's Exhibit No. 30.

<sup>562</sup> Id., at 290-1.

Q. But Solomont told you he wanted the check to his order, because he did not know to whom it ultimately was going?

A. That is correct.

Q. Without any implications, it is the same story he gave you in connection with the Insuranshares Corporation of Delaware transaction, isn't that so?

A. Yes, sir, and I trusted Mr. Solomont, unfortunately.

On the same day, October 25, 1937, when Vernon Smith of the firm of Paine, Webber & Co. returned with the securities which had been hypothecated with that brokerage firm to secure its \$580,000 advance, the securities were found to be in the name of Tucker & Co., whom Mr. Paine knew were merely nominees of J. Henry Schroder Banking Corporation.<sup>563</sup> Subsequently, Paine, Webber & Co. received from its bank the check of \$580,000 which it had delivered to Mr. Solomont and ascertained that it bore the endorsement of J. Henry Schroder Banking Corporation. These facts, however, did not arouse Mr. Paine's suspicions. On the contrary, he testified that he felt assured by the fact that J. Henry Schroder Banking Corporation was involved in the transaction, "because I knew we were doing business with responsible people."<sup>564</sup>

Moreover, on October 25, 1937, the day that the loan was made, Mr. Solomont directed Mr. Paine to segregate the securities hypothecated to secure the firm's advance of \$580,000 into two accounts—an account in the name of Solomont and Robb,<sup>565</sup> and an account in the name of Continental Securities Corporation, which Paine, Webber & Co. set up on its books as "Continental Securities Corporation No. 75."<sup>566</sup> Securities having a market value of approximately \$800,000<sup>567</sup> were segregated into the Solomont and Robb account and the balance of the securities having an approximate market value of \$2,000,000 were placed in the Continental Securities Corporation account.<sup>568</sup>

Thus, as at October 25, 1937, the very day that Paine, Webber & Co. made its advance of \$580,000 to Mr. Solomont, the firm was fully aware that the collateral it had received to secure its advance were all securities which had been derived from the portfolio of Continental Securities Corporation. Mr. Paine testified:<sup>569</sup>

Q. What did you do with the balance of the securities?

A. That is just what I asked Mr. Solomont. He stated the designation of the balance of the securities—I am quite clear in this now. He said, "I think I have here an account of Continental Securities Corporation," and I said, "That is a fairly good company; that is fine. I am glad you got that brokerage account for us"; and he said, "I don't know exactly how they want that account carried,

<sup>563</sup> Id., at 292.

<sup>564</sup> Ibid.

<sup>565</sup> Id., at 297 and Commission's Exhibit No. 42. Mr. Paine testified that when he asked Mr. Solomont "why did you open a joint account for Solomont and Robb?" Mr. Solomont explained "I, Leo Solomont, am looking after the interest of Paine, Webber & Company and Mr. Robb is looking after the interests of the other parties". (Id., at 297.)

<sup>566</sup> Id., at 298 and Commission's Exhibit No. 43.

<sup>567</sup> Id., Commission's Exhibit No. 42.

<sup>568</sup> See *supra*.

<sup>569</sup> Op. cit. *supra*, note 1, at 297-8.

so if you will give it a number we will put in the number until I find out definitely how it is to be carried."

Q. Wasn't it clear to you at that time that the whole block of securities were Continental's securities? Those securities that you had segregated out in the joint account of Solomont & Robb \* \* \* and which you carried in a street account, wasn't that clear that they were the securities of Continental Securities Corporation?

A. Yes; and I called Mr. Solomont on that and he said he had the proper papers authorizing that particular type of transaction.

However, Mr. Paine testified he had no insight into the exact nature of the transaction engaged in by Mr. Solomont and his associates, although he was informed by Mr. Solomont that the loan was made on behalf of Mr. Beverly; that the \$580,000 check of Paine, Webber & Co. was required to be made payable not to Mr. Beverly but to Mr. Solomont; that the check was endorsed over by Mr. Solomont to J. Henry Schroder Banking Corporation; that the securities ultimately turned over to Paine, Webber & Co. were in the name of a nominee of J. Henry Schroder Banking Corporation; and that Paine, Webber & Co. were directed to segregate the securities into two accounts, one for Mr. Solomont and Mr. Robb, the other for Continental Securities Corporation. Nor did Mr. Paine make any inquiries of J. Henry Schroder Banking Corporation as to the nature of the latter's participation in the transaction. Mr. Paine testified:<sup>570</sup>

Q. You knew they were Continental Securities Corporation securities on the 25th, isn't that so?

A. Yes.

Q. And yet on the 26th you sold out the Solomont and Robb account, and made checks payable to his order \* \* \*.

A. Yes, sir.

Q. \* \* \* the other one, of course, was not payable to Solomont and Robb; that was to Continental Securities Corporation?

A. Right.

Q. Now, when you saw no mention of Schroder's name or anybody associated with Schroder, or Beverly's name, or Robb or Solomont's name, in this particular instance, did you talk to Schroder to find out what it was all about?

A. No; I assumed they knew what it was all about.

On October 26, at the request of Mr. Solomont, Mr. Paine commenced to liquidate the securities in the Solomont and Robb account,<sup>571</sup> and deducted its advance of \$580,000. Thereafter, Mr. Solomont directed Mr. Paine to issue firm checks to cover the balance of the proceeds derived from the liquidation of the securities in that account as follows: two checks in the amounts of \$25,000 and \$91,246 respectively,<sup>572</sup> to be made payable to Messrs. Solomont and Robb; and two other checks in the amounts of \$122,050 and \$34,984 respectively,<sup>573</sup> to be made payable to Continental Securities Corporation.

<sup>570</sup> Id., at 309.

<sup>571</sup> Id., at 308.

<sup>572</sup> Id., Commission's Exhibits Nos. 36 and 37.

<sup>573</sup> Id., Commission's Exhibits Nos. 38 and 39.

The total of the two checks payable to Messrs. Solomont and Robb plus the \$580,000 deducted by Paine, Webber & Co. in satisfaction of its advance to Mr. Solomont, was approximately \$700,000. The corporate minutes of Continental Securities Corporation authorizing all of these payments and the other documents relating to the transactions were transmitted to Paine, Webber & Co. by Mr. Solomont on October 28, 1937, two days after the payments had been made by Paine, Webber & Co.<sup>574</sup> One of these documents was a corporate minute of Continental Securities Corporation which disclosed that, on October 25, 1937, the closing date of the contract, Continental Securities Corporation had assigned the same securities contained in the list originally exhibited to Paine, Webber & Co. when it made the advance of \$580,000 to Mr. Solomont, to one John F. McKay with a direction that he liquidate this list of portfolio securities, valued at \$700,000, and retain the proceeds in consideration of his transfer on that date of 7,000 shares of the preferred stock of Fiscal Management Company, Ltd., to Continental Securities Corporation.

Thus, on October 28, 1937, the documents in the possession of Mr. Paine disclosed that \$700,000 of the marketable portfolio securities of Continental Securities Corporation were to be replaced by 7,000 shares of the preferred stock of Fiscal Management Company, Ltd.<sup>575</sup> However, Mr. Paine testified that he "simply looked at them [the papers] casually," and made no investigation of Mr. McKay's financial status or of his connection with the \$580,000 advance to Mr. Solomont made ostensibly for Mr. Beverly.

Another document submitted<sup>576</sup> to Paine, Webber & Co. on October 28, 1937, disclosed that John F. McKay, on October 25, had assigned all of the portfolio securities, originally assigned to him by Continental Securities Corporation, to S. Leo Solomont and Ralph H. Robb. Mr. Paine testified that he was not made suspicious by "these circuitous transactions of having an assignment made to Mr. McKay and Mr. McKay in turn making an assignment to Messrs. Robb and Solomont."<sup>577</sup>

Still another document<sup>578</sup> which Paine, Webber & Co., on October 28, 1937, received from Mr. Solomont disclosed that Mr. McKay directed Messrs. Solomont and Robb to liquidate the Continental Securities Corporation portfolio securities assigned to them as follows: Messrs. Solomont and Robb were to "retain \$605,000 of the proceeds thereof in consideration for your [Solomont] advancing \$580,000 to me or my nominee. After you [Solomont and Robb] have sold said securities or any part thereof and have received for your own use \$605,000, you are to forthwith transfer, set over and assign to me, or nominee or nominees, the balance of said securities \* \* \*." This document clearly disclosed that Mr. Solomont and/or Mr. Robb were receiving \$25,000 in excess of the \$580,000 advance from Paine, Webber & Co., apparently as a "commission," although Mr. Paine testified that Mr. Solomont had informed him that he [Solomont] "was not

<sup>574</sup> Id., at 1683.

<sup>575</sup> Id., Commission's Exhibit No. 32.

<sup>576</sup> Id., Commission's Exhibit No. 33.

<sup>577</sup> Id., at 311.

<sup>578</sup> Id., Commission's Exhibit No. 148.

getting anything out of the transaction.”<sup>579</sup> In addition, the document disclosed that Mr. McKay received \$91,246.35 from Messrs. Solomont and Robb, the balance of the proceeds of the liquidation of portfolio securities with a market value of approximately \$700,000.<sup>580</sup>

#### 4. LOAN IN CONNECTION WITH ACQUISITION OF CONTROL OF INSURANSHARES CORPORATION OF DELAWARE BY NORTHERN FISCAL GROUP

It will be recalled that in September 1937 the Fiscal Management group had made an unsuccessful attempt to acquire control of Insuranshares Corporation of Delaware and that Mr. Solomont, in this connection, had approached Paine, Webber & Co. to advance \$310,000 against portfolio securities owned by Insuranshares Corporation of Delaware. Paine, Webber & Co. were to sell these securities and to apply the proceeds of such sale to their loan. Approximately two months later, in November 1937, Mr. Solomont again saw Mr. Paine “to talk about a transaction for Insuranshares.”<sup>581</sup> At this meeting, Mr. Solomont made almost the identical request for an advance by Paine, Webber & Co. to Insuranshares Corporation of Delaware which he had made in September 1937. Mr. Paine testified:<sup>582</sup>

Q. Do you recall briefly, what he said to you at that time?

A. Well, Mr. Solomont called me on the phone and said he would like to come over with Morris and Robb and talk about a transaction for the Insuranshares, and I said, “All right, come ahead.” so Mr. Solomont and Mr. Morris and Mr. Robb \* \* \* came over to my office and discussed the Insuranshares proposition.

\* \* \* \* \*

A. They told me that they had been in touch with the Insuranshares people, and that the Insuranshares people were unhappy with their investment in New England Fund, and they had several large blocks of insurance stocks which they did not think were worth holding on to. They had other securities listed on

<sup>579</sup> Id., at 1691. Mr. Paine testified that Paine, Webber & Co. had paid Mr. Solomont a fee of \$650 for his services in connection with the Continental Securities Corporation transaction. (Id., at 1617-8.)

Lothrop Withington, counsel for Paine, Webber & Co., testified that he deliberately advised the firm to withhold from the Commission the document which disclosed that \$25,000 was to be paid to “someone” for obtaining the advance of \$580,000 from Paine, Webber & Co. (id., at 1631) because he was of the opinion that the document had not been contained in the papers delivered by Mr. Solomont to Mr. Paine on October 28, 1937. Mr. Withington testified that he was of the opinion that this document had been inserted in the files of Paine, Webber & Co. sometime after February 1938 (id., at 1641) when Mr. Solomont had removed and subsequently returned the records of Paine, Webber & Co., relating to the Continental Securities Corporation transaction. (Id., at 1625-6.) Mr. Withington further testified that he advised withholding the document so that Mr. Solomont could be confronted with the document on cross-examination when he testified as to his participation in the transaction.

Mr. Solomont, as well as Messrs. Ferretti, Frear, Robb, Morris, and Clayton never testified at the hearings conducted by the Securities and Exchange Commission because these individuals had been indicted for grand larceny by the Grand Jury of New York County, New York, one day before these hearings were scheduled to commence.

<sup>580</sup> Id., Commission's Exhibit No. 148.

<sup>581</sup> Id., at 350.

<sup>582</sup> Id., at 350-1.

the Stock Exchange and they were considering making an entirely different plan in connection with the operation of their company.

Insuranshares Corporation I knew was a small proposition, and it was not an unusual thing for them to discuss a proposition of this sort so I said, "What do you want to do?" And they said, "We are considering making an investment in another company; they want to liquidate or rather cancel the New England Fund stock."

I said, "How much will that bring?" and they said, "You go out and find out how much it is worth." and so I called the New England Fund and found out it was worth somewhere between \$260,000 and \$280,000.

I said, "Is that the money you want for that New England Fund?", and they said, "No; we want two or three hundred, or three hundred and ten thousand dollars," and I said, "What you want me to do is simply cash in the New England Fund and make a small loan on some of your other securities," and they said, "Yes; that is all there is in the program at this time," and so I said, "That is all right, that sounds all right to me." and they left.

However, Mr. Paine was aware of the fact that in connection with this transaction Mr. Solomont was acting for principals who intended to purchase control of Insuranshares Corporation of Delaware. On December 1, 1937 Mr. Paine wrote to Frank Hope, a partner in the New York office of Paine, Webber & Co., as follows: <sup>583</sup>

The plan is to give a certified check to Mr. Solomont for \$310,000 and he will go to New Jersey with his principals, pay over the money and receive back negotiable stocks and bonds in accordance with the list.<sup>584</sup> They will bring them back to us and we will sell all that is necessary in order to get around the margin rules of 40%. If that worries you, we buy the New England Fund from them on a principal basis as we can turn it into the New England Fund on that basis as soon as received.<sup>585</sup>

I believe this is a starter for considerable business which the new buyers of Insuranshares Corporation hope to turn our way.

Mr. Paine also was cognizant of the fact that the portfolio securities which his firm was to liquidate for Insuranshares Corporation of Delaware were to be replaced by stock in a "Canadian investing company." <sup>586</sup> However, Mr. Paine denied <sup>587</sup> that he knew that Messrs. Solomont, Robb and Morris were the "principals" referred to in his letter to Mr. Hope as the "new buyers" of control of Insuranshares Corporation of Delaware.

As Mr. Paine's letter indicates, the stock of New England Fund held by Insuranshares Corporation of Delaware, since it was an unlisted security, could not under Regulation T of the Federal Reserve Board (the regulation of the board relating to margin requirements) be accepted by a broker as collateral for a loan. Accordingly Mr. Paine suggested to Mr. Solomont that in order to effect the transaction "the Insuranshares people themselves vote to cash this stock in

<sup>583</sup> Id., Commission's Exhibit No. 151.

<sup>584</sup> All securities contained in the list annexed to the letter were portfolio securities of Insuranshares Corporation of Delaware.

<sup>585</sup> New England Fund, as has previously been stated, was an open-end investment trust which at the option of the holders of its certificates of beneficial interest was required to redeem such certificates in cash at their approximate asset value. See *supra*, p. 443.

<sup>586</sup> Op. cit. *supra*, note 1, at 1702.

<sup>587</sup> Id., at 1697.



so there would not be any question about anything to do with Regulation T.”<sup>588</sup> Mr. Paine testified:<sup>589</sup>

Q. \* \* \* I am conscious of the fact that the New England Fund was one of the securities, and that it was not available as collateral; you made the suggestion that they sell it and therefore you would only have to advance \$40,000 on the balance of the securities.

A. That is correct.

Q. Now in order to start with a cash transaction and not a margin transaction the cash would have had to be up with Paine, Webber & Co. before you could issue a check against the securities, isn't that so?

A. Well, my understanding of the regulation is that you can sell the security—make the sale of unregistered securities and advance cash, provided you know that the money is coming in within a day or two.

Q. That is if it were a cash transaction?

A. Yes.

On December 21, 1937, the date of the closing of the contract of the Northern Fiscal group to purchase control of Insuranshares Corporation of Delaware, Paine, Webber & Co., prior to the receipt by that firm of any authorization of Insuranshares Corporation of Delaware to deliver its portfolio securities to Paine, Webber & Co. to secure the advances, and in fact prior to the physical receipt of the securities by the firm, drew six checks aggregating \$310,000 to the order of the individuals who were selling a total of approximately 78,000 shares of Insuranshares Corporation of Delaware stock to the Northern Fiscal group.<sup>590</sup> These checks were ultimately delivered to the individuals to whom they were made payable. Mr. Paine testified that from these checks it was obvious, at least in retrospect, that Mr. Solomont's "principals"<sup>591</sup> were purchasing control of Insuranshares Corporation of Delaware with that company's own funds. At the time these checks were issued, however, Mr. Paine testified that he was "simply interested in the amount of money involved"<sup>592</sup> and "whatever Mr. Solomont wanted to do was quite all right, so if he did ask my approval of these checks I probably gave it to him."<sup>593</sup> The fact that Paine, Webber & Co. was asked by Mr. Solomont to issue six separate checks to cover the \$310,000 advance did not apparently create any suspicion in the mind of Mr. Paine. Mr. Paine testified:<sup>594</sup>

Q. Now these checks, you notice, do you not, Mr. Paine, that they were made to Fidelity Philadelphia Trust Company, George A. Burnell, David Morris, Harry M. Blair, and another one to Beverly, Robb or Solomont, Harry Blair or Solomont, David Morris or Solomont, Arthur C. Logan, Receiver of Continental Sea-

<sup>588</sup> Id., at 352. On December 16, 1937, five days prior to the date of the passage of control of the corporation to the Northern Fiscal group, the retiring board of directors of Insuranshares Corporation of Delaware, all of whom were either the owners or represented the owners of Insuranshares Corporation of Delaware stock which were to be sold to the Northern Fiscal group, authorized the transfer of the 21,500 certificates of beneficial interest in New England Fund owned by Insuranshares Corporation of Delaware to the name of S. Leo Solomont on his becoming the new treasurer of Insuranshares Corporation of Delaware. See *supra*, note 414.

<sup>589</sup> Op. cit. *supra*, note 1, at 352-3.

<sup>590</sup> Id., Commission's Exhibit No. 49.

<sup>591</sup> Id., Commission's Exhibit No. 151.

<sup>592</sup> Id., at 361.

<sup>593</sup> Ibid.

<sup>594</sup> Id., at 365-6.

board, another check to Logan, Fahnstock & Company; now, wasn't it obvious to you at that time that \$310,000 was being paid to people who had small blocks of stock that they were accumulating?

A. No, sir; because I never saw the checks until the investigation started.

Q. Looking at it now, isn't it obvious to you now that \$310,000 was being used towards purchasing similar blocks of stock either being held in the bank name or street or in individual names; isn't that so?

A. Well, a lot of this stuff is obvious now, but it was not then.

Q. Didn't Vernon Smith tell you that he was drawing these small sized checks to these various individuals?

A. No; he said several checks.

Q. You never asked Solomont why he needed small checks?

A. As a matter of fact, I did not.

Q. The fact is that the sound, healthy, usual way of doing business, if the Insuranshares Corporation of Delaware was out to buy securities in the open market, or blocks of stock, would be for them to issue their checks and issue them to the various individuals whose securities they were buying, isn't that so?

A. Well, that was a small corporation, and if they asked for three checks as a convenience to them or their client, or whoever they were doing business with, I don't think I would have considered it unusual.

On December 21, 1937 Paine, Webber & Co. received the portfolio securities of Insuranshares Corporation of Delaware which Mr. Solomont had agreed to deliver to the firm as collateral for its advances.<sup>595</sup> Mr. Solomont directed Mr. Paine to place these portfolio securities into a joint account in the name of Solomont and Robb. Mr. Paine relied on the assurance of Mr. Solomont that he had the votes necessary to authorize the transfer of these securities to the Solomont and Robb account.<sup>596</sup> However, Mr. Paine did not see any authorization to this effect from Insuranshares Corporation of Delaware until December 23, 1937.<sup>597</sup>

The documents<sup>598</sup> delivered to Mr. Paine on that date disclosed (1) that Insuranshares Corporation of Delaware had purchased from one Arthur Quint 5,000 shares of the preferred stock of Northern Fiscal Corporation, Ltd., and that portfolio securities of Insuranshares Corporation of Delaware had been assigned to Arthur Quint, who was to liquidate these securities and deduct \$500,000 in payment for these 5,000 shares of preferred stock of Northern Fiscal Corporation, Ltd., and to deliver the balance of the proceeds to Insuranshares Corporation of Delaware, and (2) that Arthur Quint as part of the same transaction had assigned all these portfolio securities of Insuranshares Corporation of Delaware to Messrs. Solomont and Robb. The documents further disclosed that Messrs. Solomont and Robb were officers of Insuranshares Corporation of Delaware.<sup>599</sup> According to Mr. Paine, when he questioned Mr. Solomont about the fact that Messrs. Solomont and Robb were officers of Insuranshares Corporation of Delaware, Mr. Solomont stated that he and Mr. Robb were representing Mr. Quint.<sup>600</sup>

<sup>595</sup> Id., at 365.

<sup>596</sup> Id., at 364.

<sup>597</sup> Ibid.

<sup>598</sup> Id., Commission's Exhibit No. 48.

<sup>599</sup> Id., at 360.

<sup>600</sup> Ibid.

Mr. Paine conceded that, in view of all these circumstances, he considered the entire Insuranshares Corporation of Delaware transaction in which his firm had participated, "unusual." He testified:<sup>601</sup>

Q. By that time, Mr. Paine, were you not getting suspicious? Here is a lawyer becoming president of the investment trust, taking the investment trust securities and putting them in his joint account and getting resolutions to the effect that this procedure is all right.

A. At the time of the Insuranshares transaction, I thought it was unusual, but inasmuch as I was still doing business with the Continental Securities Corporation, which is shown by the statement, I did not think much about it.

Q. But looking back in retrospect, that was a very suspicious circumstance?

A. I thought it was a little unusual in seeing their names on the paper, and therefore I asked him for those papers, but I was not at all worried because I was still doing business with Continental.

## 5. LOAN IN CONNECTION WITH ACQUISITION OF CONTROL OF BURCO, INC.

On February 28, 1937, Stephen Paine was informed by one of his partners, Albert Evart, that Mr. Solomont "had another transaction in mind" and that, in the absence of Mr. Paine, Mr. Evart had referred Mr. Solomont to the New York office of Paine, Webber & Co.<sup>602</sup> This loan, which was used by the Northern Fiscal group in connection with their acquisition of control of Burco, Inc., was handled by Frank Hope, a partner of Paine, Webber & Co. in charge of its New York City office.

Mr. Hope testified that, on or about February 26, 1937, he had been informed by Mr. Evart that "Mr. Solomont was coming in with some more business."<sup>603</sup> Mr. Hope was aware that the previous business brought by Mr. Solomont to Paine, Webber & Co. had related to investment trusts. Mr. Hope testified:<sup>604</sup>

Q. When you say with "more business," you mean that he told you about the previous business he brought in?

A. I knew there was some business before then.

Q. Some business in connection with investment trusts?

A. Yes; I knew they were investment trusts.

The proposition presented by Mr. Solomont to Mr. Hope and Sullivan & Cromwell, the New York attorneys for Paine, Webber & Co., was to have Paine, Webber & Co. advance \$290,000 on a list of securities exhibited to them by Mr. Solomont.<sup>605</sup> Apparently, however, Mr. Solomont and his associates needed \$340,000 for they had requested Paine, Webber & Co. to advance its check for \$340,000,<sup>606</sup> of which \$290,000 would constitute the advance on the securities exhibited in the list to Mr. Hope and \$50,000 would represent a certified check in that amount to be given by Mr. Solomont and his associates to Paine, Webber & Co.<sup>607</sup> A check for \$340,000

<sup>601</sup> Id., at 365.

<sup>602</sup> Id., at 371-372.

<sup>603</sup> Id., at 374.

<sup>604</sup> Id., at 374.

<sup>605</sup> Id., at 379-380. The securities contained in the list were the portfolio securities of Burco, Inc.

<sup>606</sup> Ibid.

<sup>607</sup> Ibid.

was drawn by Paine, Webber & Co. payable to the Guaranty Trust Company,<sup>608</sup> which then drew a cashier's check for \$340,000 payable to the order of Solomont or Graham, McMahon, Buell & Knox,<sup>609</sup> counsel for Carroll E. Gray, Jr., the seller of the Burco, Inc. stock.

Mr. Hope testified that, relying on the advice of Sullivan & Cromwell, the transaction did not appear to be improper to him:<sup>610</sup>

Green [a member of the firm of Sullivan & Cromwell] asked them [Solomont, Morris, and Robb] what kind of a deal it was, did they know the parties well, had they done business before, were they parties of good reputation and some other questions that I can not remember. Green finally turned to me and I said "I think if you want to do the business it is all right to do it, but I wish you—don't go now, I want to talk to you about something else." So I telephoned back to the office that they could go ahead with the deal.

On March 3, 1938 Paine, Webber & Co. advanced \$290,000 to Mr. Solomont and on the same day received the securities contained in the list previously exhibited by Mr. Solomont to the firm,<sup>611</sup> which securities were set up on the books of Paine, Webber & Co. as the "S. Leo Solomont & Ralph H. Robb, Jr. A/C."<sup>612</sup>

Mr. Hope, as has already been indicated, testified that he was aware of the fact that all previous "business" which Mr. Solomont had brought to Paine, Webber & Co. had involved investment companies. And Mr. Paine testified that the Robb and Solomont joint account which had been set up on the books of Paine, Webber & Co. in connection with the Insuranshares Corporation of Delaware advance made by the firm had aroused his suspicions. However, he testified that in this last transaction involving Burco, Inc. his "suspicions were allayed" by the fact that the transaction had been approved by the New York counsel of Paine, Webber & Co.:<sup>613</sup>

Q. Now here again we find that the securities were put in the name of Solomont and Robb, which was the situation which you said made you suspicious in the Insuranshares deal; isn't that so?

A. Yes; but my suspicions were allayed because the New York counsel knew all about it. I assumed.

Q. It was unusual, was it not, to carry securities of an investment in the name of lawyers?

A. Not if the attorneys approved it.

Q. The attorneys may have given it their blessing, but, as a matter of practice, it was unusual, was it not, that the securities of an investment trust should be carried in the names, personally, of their officers or lawyers; isn't that so?

A. That may be so.

Q. How many times in your history have you ever carried the securities of even an ordinary corporation or an institution like an insurance company, or a bank, or an investment trust in the name of its officers and directors?

A. Sometimes we carry accounts for liquidating by various groups in the names of individuals.

<sup>608</sup> Id., Commission's Exhibit No. 57.

<sup>609</sup> Id., Commission's Exhibit No. 58.

<sup>610</sup> Id., at 375.

<sup>611</sup> Id., at 1720.

<sup>612</sup> Id., at 381 and Commission's Exhibit No. 59.

<sup>613</sup> Id., at 381-2.

Q. By that you mean various groups of individuals, but not investment trusts or corporations; you would not carry those securities in the names of individuals?

A. Not without papers; no, sir.

On March 3, 1938 Paine, Webber & Co. proceeded to sell the securities. By March 8, 1938 Paine, Webber & Co. had liquidated a portion of the securities for proceeds of approximately \$390,000.<sup>614</sup> From these funds, Paine, Webber & Co. deducted its \$290,000 advance.

On March 8, 1938, Paine, Webber & Co. received from Mr. Solomont a letter of assignment, dated March 3, 1938, of a list of securities by one Howard F. Hansell, Jr. to Mr. Solomont.<sup>615</sup> This letter authorized Mr. Solomont to sell a part of these securities, which were the identical securities which Paine, Webber & Co. had set up in the "S. Leo Solomont and Ralph H. Robb, Jr." joint account on March 3, 1938. From the proceeds of this sale, Mr. Solomont was to repay the advance of \$340,000 which Mr. Solomont had procured for the account of Mr. Hansell and which Mr. Hansell had authorized to be paid to Graham, McMahon, Buell & Knox<sup>616</sup> for the Burco, Inc., stocks. The balance of the securities were to be delivered to Mr. Hansell. The letter also indicated that Mr. Hansell had acquired the securities which were being liquidated from Burco, Inc. for "good and valuable considerations." Mr. Paine, although he saw this letter, "paid no attention" to it. He testified, "I had the attorney's approval finally on the transaction and my interest was only to take orders from the people who had possession of the securities."<sup>617</sup>

On March 11, 1938 Mr. Paine received information that "there had been some talk about Continental Securities transactions"<sup>618</sup> and became suspicious. Mr. Paine testified, "Well, if there is some talk about that, why we better stop doing business with these people."<sup>619</sup> Accordingly, Mr. Paine's attorney, Lothrop Withington, on March 15, 1938, held a conference with Messrs. Solomont, Morris, and Robb. As a result of this conference Messrs. Solomont and Morris agreed that they would get the "papers" authorizing the sale of the securities in the Solomont and Robb joint account and the payments from that account which had already been effected.<sup>620</sup>

On March 16, 1938 Messrs. Withington and Paine received from Messrs. Morris and Solomont certain resolutions of Burco, Inc.<sup>621</sup> which, when coupled with the letter of assignment from Mr. Hansell to Mr. Solomont, indicated that (1) Mr. Hansell had sold to Burco, Inc., blocks of the stock of Delta Oil Company, Ltd. and Insuranshares Corporation of Delaware for a total consideration of \$750,000; (2) that Burco, Inc. had authorized the delivery to Mr. Hansell of portfolio securities (which were identical with those placed on March 3, 1938, by Paine, Webber & Co. in the Solomont and Robb joint ac-

<sup>614</sup> Id., at 388.

<sup>615</sup> Id., Commission's Exhibit No. 55.

<sup>616</sup> These were the attorneys for Carroll E. Gray, Jr., who had on March 3, 1938, sold control of Burco, Inc., to the Northern Fiscal group. See *supra*, p. 463 and note 497.

<sup>617</sup> Id., at 378.

<sup>618</sup> Id., at 384.

<sup>619</sup> Ibid.

<sup>620</sup> Id., at 1646-7.

<sup>621</sup> Id., Commission's Exhibits Nos. 55, 56.

count); (3) that Mr. Hansell was authorized to liquidate sufficient of such securities to derive the sum of \$750,000; and (4) that Mr. Hansell had assigned the securities to Mr. Solomont, who was authorized to sell an amount of such securities sufficient to repay the advance of \$340,000 which Mr. Solomont had obtained for Mr. Hansell's account and had paid to Graham, McMahon, Buell, and Knox.<sup>622</sup>

At this point, had Paine, Webber & Co. inquired of Graham, McMahon, Buell, and Knox the reason for the \$340,000 payment to that firm by Mr. Hansell, there would have been disclosed the fact that Mr. Hansell and his associates had purchased control of Burco, Inc. by the use of that investment company's own assets. However, Mr. Withington, the attorney of Paine, Webber & Co., who at this time interrogated Mr. Hansell and Americus J. Leonard, the president of Burco, Inc., as to the value of the shares of Delta Oil Company, Ltd. and Insuranshares Corporation of Delaware,<sup>623</sup> apparently did not inquire into the \$340,000 payment by Mr. Hansell to Graham, McMahon, Buell, and Knox.<sup>624</sup>

As a result of these conferences, the designation of Solomont and Robb joint account on the books of Paine, Webber & Co. was modified by adding the notation, "Burco A/C."<sup>625</sup> On March 16, 1937 the unsold securities<sup>626</sup> and the cash remaining in the account of Solomont and Robb, Burco A/C with Paine, Webber & Co. were transferred to the officers of Burco, Inc. and the account terminated.<sup>627</sup>

The total commissions to Paine, Webber & Co. in all its transactions in connection with all these investment companies aggregated \$16,000. When examined as to the obligation of Paine, Webber & Co. to these investment companies and the actual and possible benefits to that firm, Mr. Paine testified:<sup>628</sup>

Q. You say you acted strictly in a brokerage capacity. The fact of the matter is that you became conscious in each instance before you actually started the liquidation of the securities that you were acting as broker or agent for an investment trust; isn't that so?

A. I would not imply that.

Q. Now let us see. With respect to First Income Trading Corporation, you were not there?

A. That is right.

Q. But with respect to the Continental Securities Corporation, you said late in the afternoon of the 25th of October, when Robb or Solomont asked you to segregate the securities, you knew then that these were Continental Securities

<sup>622</sup> See note 616.

<sup>623</sup> Mr. Withington testified (*id.*, at 1648-9):

Q. Did he [Howard F. Hansell, Jr.] also tell you that he had bought control of Burco, Inc.?

A. No; at that time there was no mention of control of Burco. I didn't know about that until a subsequent date.

<sup>624</sup> *Id.*, at 1648-9.

<sup>625</sup> *Id.*, at 1649-50 and Commission's Exhibit No. 59.

<sup>626</sup> It will be recalled that Paine, Webber & Co. had previously liquidated securities in this account for proceeds of \$390,000. From these proceeds, Paine, Webber & Co. had deducted \$290,000, the amount of their advance to Mr. Solomont. The securities remaining in the account were thereafter delivered by the officers of Burco, Inc., to Howard F. Hansell, Jr., in satisfaction of its obligation to meet the final payments due on the purchase from Mr. Hansell of the common stock of Delta Oil Company, Ltd. and Insuranshares Corporation of Delaware. See *supra*, p. 465.

<sup>627</sup> *Op. cit. supra*, note 1, at 1650-1.

<sup>628</sup> *Id.*, at 390-3.

Corporation stock—I think you did say you did not know that the Schrodgers had sold control—although with respect to Continental Securities Corporation you knew you were the broker for Continental Securities Corporation; isn't that so?

A. Yes.

Q. And your primary obligation as agent and your fiduciary duty was to Continental Securities Corporation, isn't that so?

A. Well, we naturally would expect to get title to the securities which were sold for any account, if they were Continental stocks; yes, sir.

Q. And that is true of Insuranshares Corporation of Delaware; you knew you were acting as broker for Insuranshares Corporation of Delaware, didn't you?

A. Yes, sir.

Q. You knew that was so with Bond and Share Trading Corporation?

A. That was a straight transaction, I mean there was no loss on that.

Q. And then you knew that with respect to Burco, too, did you not?

A. Yes.

Q. Now you say that the only remuneration that you received was \$16,000. Now, candidly, Mr. Paine, you do not deny, do you, that consciously or unconsciously you had it in the back of your mind that you would get the account for these investment trusts, isn't that so?

A. Naturally, we assumed that we were going to continue to do business with these people.

Q. And the fact of the matter is that though ultimately it did not turn out that way, when you did the business you expected you would get the account of Continental Securities Corporation which had about four million dollars in assets at that time, isn't that so?

A. Two and one-half million, as far as I know.

Q. And one of the best brokerage clients in the world, is an investment trust, isn't that so? Because that is their business, buying and selling securities?

A. That is correct.

Q. And not only are they the best customers because they continually buy and sell securities, but they always buy for cash and do not have any margin accounts, do they?

A. That is usually the case.

Q. They are the finest commission business in the world, isn't that so, if you can get it?

A. Yes.

Mr. Paine conceded that his relationship of broker to the various investment companies which came under the control of the Fiscal Management and Northern Fiscal groups might have created a fiduciary relationship between the investment companies and his firm. Nevertheless, he testified that his suspicions were not aroused in any way by the fact that his firm received from the officials of the investment companies only orders to liquidate their portfolio securities as rapidly as possible to satisfy the advances made by his firm, with only one order to purchase securities. Furthermore, the fact that immediately after sufficient securities were sold to repay these advances, the brokerage accounts of several of the investment companies with Paine, Webber & Co. were transferred to Prentice & Brady apparently also did not impress Mr. Paine as a questionable circumstance. Mr. Paine testified:<sup>629</sup>

<sup>629</sup> Id., at 386-9.

Q. In all these transactions I notice one thing, Mr. Paine, that starting with the First Income Trading Corporation, Continental Securities Corporation, Insuranshares Corporation of Delaware, Bond and Share Trading Corporation, and Burco, Inc., five different investment companies with which Paine, Webber & Company was associated and you know what I mean by associated—

A. Brokerage.

Q. Did you ever buy a single share of stock for any one of these trusts?

A. I think we bought some Insuranshares stock at \$1.00 a share.

Q. No; what I mean is did you ever act as broker for any one of those trusts and execute a single buy order for them?

A. I say we did buy Insuranshares for Solomont and Robb, Insuranshares, I think 2,400 shares of Insuranshares stock.

Q. But every other single transaction that you had during the entire history, starting in August and terminating in about March, through that period the only thing which Paine, Webber & Company did was to sell, isn't that so?

A. Well, there is a notation on these of Interborough Rapid Transit, and we bought one stock which was sold; otherwise you are correct.

Q. Wasn't it becoming patent and apparent to you that these people were selling out and liquidating the portfolio of the various trusts and except in negligible instances, was there a single order to buy executed by Paine, Webber & Company for any of these investment trusts?

A. Don't forget that we delivered, after selling the securities of First Income Trading, we delivered over a million dollars of securities for Continental Securities, and we had no knowledge of what was going to happen to it. We did not know whether everything was selling, or not; we had no idea.

Q. So far as your end of it was concerned, it was a sale?

A. Yes; actual brokerage orders on the selling side; yes, sir.

Q. How many dollars of securities did you sell in this entire picture? How much did you sell in First Income Trading, do you remember?

A. About \$150,000 worth.

Q. And how much did you sell in Continental Securities Corporation?

A. I should say \$1,400,000.

Q. And how much did you sell in Insuranshares Corporation of Delaware?

A. I should say about \$480,000.

Q. And how much did you sell in Burco, Inc.?

A. About \$390,000, and we liquidated some other stock which Burco had on a loan afterwards of about \$200,000.

Q. And then you sold about \$70,000 in Bond and Share Trading Corporation, isn't that so?

A. I think that is the amount.

Q. Approximately how much is it?

A. \$2,700,000.

Q. \$2,700,000 of securities.

A. In five accounts; that is not a very tremendous amount because Continental's portfolio was \$2,500,000.

Q. Well, it may not be a tremendous amount where you buy and sell, but in the light of the facts I have just developed, it was a lot of selling, wasn't it?

A. We executed a great deal more than that in a very short time in previous years.

As a result of the association of Paine, Webber & Co. with the acquisition of control of investment companies by the Fiscal Management and Northern Fiscal groups, the Board of Governors of



the New York Stock Exchange suspended Stephen Paine for a period of three years from membership on the New York Stock Exchange. The substance of the "charges and specifications" of the Board of Governors was that "he (Stephen Paine) either knew the facts and circumstances in the light of which he should not have permitted or should have prevented (1) certain advances or loans by the firm of Paine, Webber & Co. for the account of certain individuals which were used for the purchase of control of Continental Securities Corporation, Insuranshares Corporation of Delaware, and Burco, Inc., investment trusts, securities from the portfolios of which investment trusts were used as collateral to secure such advances or loans and later sold in order to liquidate such advances or loans, and (2) certain transactions made in the joint account of said individuals involving securities from the portfolios of such investment trusts, or he was aware of circumstances which in the exercise of ordinary diligence demanded an investigation and failed to make proper investigation."

Frank Hope, another partner in the firm, was suspended for a period of six months, on the ground "\* \* \*" that he either knew facts and circumstances in the light of which he should not have permitted or should have prevented an advance or loan by the firm of Paine, Webber & Co. for the account of certain individuals which was used for the purchase of control of Burco, Inc., an investment trust, securities from the portfolio of which investment trust were used as collateral to secure such advance or loan, or he was aware of circumstances which in the exercise of ordinary diligence demanded an investigation and failed to make a proper investigation."<sup>630</sup>

### E. Participation of Prentice & Brady in the Activities of the Fiscal Management Group

The brokerage firm of Prentice & Brady, it will be recalled, figured prominently in the activities of the Fiscal Management group. George H. Clayton, Jr., a member of the Fiscal Management group, was a close associate of Jerome C. Brady, one of the partners in the firm of Prentice & Brady,<sup>631</sup> sharing an office with Jerome C. Brady.<sup>632</sup> Presumably, as a result of this association, the firm of Prentice & Brady not only received commissions in connection with the sale of control of Reynolds Investing Company, Inc., but also received commissions as the broker in the liquidation of the portfolio securities of the various investment companies acquired by the Fiscal Management group.

<sup>630</sup> *The New York Times*, April 1, 1939. On May 31, 1939, a Federal Grand Jury in the Southern District of New York indicted Messrs. Morris, Solomont, Hansell and Paine, among others, on 17 counts of mail fraud and one of conspiracy in connection with Insuranshares Corporation of Delaware and Burco, Inc. (*The New York Times*, June 1, 1939.) On December 1, 1939 Messrs. Morris, Solomont, Hansell and Paine were convicted in the United States District Court for the Southern District of New York as participants in a conspiracy involving the use of the mails to defraud the stockholders of Insuranshares Corporation of Delaware and Burco, Inc. (*The New York Times*, December 2, 1939.)

<sup>631</sup> Op. cit. supra, note 1.

<sup>632</sup> Ibid.

## 1. ACTIVITIES IN CONNECTION WITH ACQUISITION OF CONTROL OF FIRST INCOME TRADING CORPORATION AND CONTINENTAL SECURITIES CORPORATION

Prentice & Brady became the brokers for First Income Trading Corporation immediately after Paine, Webber & Co. had liquidated sufficient portfolio securities of this investment company to satisfy the advances which that firm had made to the group who acquired control of the company.<sup>633</sup> In addition, Prentice & Brady received \$48,000 in brokerage commissions in connection with the liquidation of the balance of the portfolio securities of Continental Securities Corporation, which were turned over to Prentice & Brady immediately after Paine, Webber & Co. had sold sufficient of these portfolio securities to reimburse that firm for its \$580,000 advance to the group to buy control of Continental Securities Corporation.<sup>634</sup>

Furthermore, Prentice & Brady received, as a result of their association with the Fiscal Management group, \$160,000 of the funds of Continental Securities Corporation. Of this sum, \$80,000 was used by Prentice & Brady to purchase a seat on the New York Stock Exchange for one Mr. Lynch, who subsequently became a partner in the firm of Prentice & Brady; \$20,000 was paid to Mr. Clayton; and \$60,000 was disbursed in "various small loans" to "various people."<sup>635</sup>

## 2. ACTIVITIES IN CONNECTION WITH ACQUISITION OF CONTROL OF REYNOLDS INVESTING COMPANY, INC.

In the acquisition of control of Reynolds Investing Company, Inc., Sartell Prentice, of Prentice & Brady, ostensibly acted as the principal and publicly announced that he acted in that capacity.<sup>636</sup> It will be recalled that C. K. Reynolds testified that the fact that Mr. Prentice was reputed to be related to the Rockefeller family was one of the factors which induced the Reynolds family to sell their controlling block of stock of Reynolds Investing Company, Inc. to Mr. Prentice. Actually, however, as has already been described, Sartell Prentice was acting in the negotiations for the acquisition of control of Reynolds Investing Company, Inc. only as agent for the undisclosed principal, the Fiscal Management group. Control of Reynolds Investing Company, Inc., was ultimately acquired by Continental Securities Corporation, which was at that time controlled by the Fiscal Management group. Prentice & Brady acted as the brokers in the liquidation of the portfolio of Continental Securities Corporation and also in the liquidation of a substantial portion of the portfolio of Reynolds Investing Company, Inc., in order to raise the cash necessary to meet the payments on the contract to purchase control of Reynolds Investing Company, Inc. In connection with this acquisition of control, Prentice & Brady without authorization hypothe-

<sup>633</sup> See *supra*, p. 359.

<sup>634</sup> *Op. cit. supra*, note 1, at 593.

<sup>635</sup> See *supra*, p. 407.

<sup>636</sup> See *supra*, p. 425, note 306.

cated customers' securities with banks for loans; hypothecated for loans with various banks, without the prior authority of the board of directors, the portfolio securities of Reynolds Investing Company, Inc., which had been removed from that company's vault; and subsequently liquidated these portfolio securities without the prior authority of the board.

Prentice & Brady received a total of \$52,000 in "commissions" in connection with acquisition of control of Reynolds Investing Company, Inc., and the liquidation of the securities of that investment company.<sup>637</sup>

In April 1938, Messrs. Prentice and Brady were expelled from the New York Stock Exchange by the Committee on Business Conduct, upon the ground that the firm had made improper use of customers' securities.<sup>638</sup> In May 1938 the Attorney General of New York obtained an injunction in substance restraining the firm of Prentice & Brady from engaging in any security activities with collateral on investment trusts.<sup>639</sup> In November 1938 a federal grand jury for the Southern District of New York indicted, among others, Sartell Prentice and Jerome C. Brady as alleged participants in a conspiracy to use the mails to defraud the stockholders of First Income Trading Corporation, Continental Securities Corporation, and Reynolds Investing Company, Inc.<sup>640</sup>

## F. Conclusion

Within the period of six months from October 1937 to March 1938, the Fiscal Management and Northern Fiscal groups were able, without the expenditure of any of their own funds, to acquire control of seven investment companies with aggregate assets of approximately \$14,600,000. During this same period, an aggregate of approximately \$6,000,000 of marketable assets of investors in these organizations were either dissipated in the form of "commissions," "profits," and loans to, and purchases of valueless securities from the members of the group and their associates or were replaced with assets of a most doubtful value.<sup>641</sup> After the passage of control of these investment

<sup>637</sup> Op. cit. supra, note 1, at 593.

<sup>638</sup> *The New York Times*, April 27, 1938, p. 32.

<sup>639</sup> Id., May 28, 1938, p. 1.

<sup>640</sup> Jerome C. Brady and Sartell Prentice, both of whom were subpoenaed by the Securities and Exchange Commission to testify at its public examination into the activities of the Fiscal Management group, asserted their constitutional privilege of refusing to testify on the ground that their answers might tend to degrade or incriminate them. (Op. cit. supra, note 1, at 118-121.)

Various criminal proceedings which were instituted in connection with the activities of the Fiscal Management group and Northern Fiscal group are (1) indictments by the Grand Jury, County of New York, of Messrs. Frear, Ferretti, Clayton, Solomont, Robb, and Morris for grand larceny. All of these defendants, except Mr. Robb, who pleaded guilty, were acquitted June 9, 1939. (2) Indictments by Federal Grand Jury for the Southern District of New York of members of the Fiscal Management group and various others including Stephen Paine as alleged participants in a conspiracy to use the mails to defraud. These indictments were still pending at the date of this report.

<sup>641</sup> The following schedule indicates the value of the diversified marketable securities and other assets of the various investment companies acquired by the Fiscal Management and Northern Fiscal groups prior to the passage of their control to such groups; and the dollar amount of these assets which were invested in securities of other investment companies (most of which had nominal or no asset values), in the preferred stocks of Fiscal Management Company, Ltd., and of Northern Fiscal Corporation, Ltd. (the personal holding companies of the groups), in large blocks of stocks of doubtful value, and in loans

companies to these groups, five of these seven investment trusts ultimately were placed in receivership or reorganization to prevent further depletion of their assets by the members of the groups.

The individuals in the groups acquired control of these various investment companies by the device of using the funds of the very investment companies acquired to pay for the controlling blocks of stock of these organizations. However, these schemes could not have been consummated had the old managements and dominant stockholders not turned over control of the funds which "belonged" to the investing public.

The old managements owed a high fiduciary obligation to the investors arising from the various capacities in which they were associated with their investment companies and security holders. In most instances the persons who transferred control had sponsored the investment trusts, distributed the securities of these investment trusts, managed the funds of these organizations, and were officers and directors and controlling stockholders.

The public investors in these companies had a right to expect a strict and continuous observance of these obligations. The investing public, apparently motivated by a desire to be in a senior or protected position, purchased the bonds, debentures, and preferred stocks of these investment companies. For this protection, these senior security holders were apparently willing to limit the extent of their partici-

to the members of the groups or their associates. These figures do not include all the "commissions" and "profits" taken by the members of the groups and associates on various deals by and with the investment companies, nor does it include Administered Fund Second, Inc., which had assets of approximately \$3,500,000, since these funds were not "touch" by the Fiscal Management group.

Name of investment company	Approximate aggregate value of net assets prior to transfer of control	Disposition of assets acquired by Fiscal Management and Northern Fiscal group
Bond and Share Trading Corporation.	\$230,000	\$175,000 used to purchase preferred stock of Northern Fiscal Corp., Ltd.
Burco, Inc. ....	1,250,000	{ \$25,000 used to purchase common stock of Insuranshares Corporation of Delaware. \$725,000 used to purchase common stock of Delta Oil Co., Ltd. \$1,900,000 used to purchase common stock of Reynolds Investing Co., Inc. \$354,500 used to purchase common stock of Corporate Administration, Inc.
Continental Securities Corporation.	3,300,000	{ \$447,000 paid on contract to purchase collateral notes of American Utilities Corp. \$160,000 advanced to Prentice & Brady and others. \$103,000 used to purchase common stock of Barkley-Grow Aircraft Corp. \$217,000 used to purchase common stock of Reynolds Investing Co., Inc.
First Income Trading Corporation.	540,000	{ \$125,000 used to purchase common stock of Barkley-Grow Aircraft Corp. \$88,000 used to purchase various mining and oil stocks. \$31,000 advanced to Messrs. Grow and Wicks.
Insuranshares Corporation of Delaware.	800,000	{ \$175,000 used to purchase class A and B stock of Bond and Share Trading Corp. \$325,000 used to purchase preferred stock of Northern Fiscal Corp., Ltd.
Reynolds Investing Co., Inc.	5,000,000	\$882,500 used to purchase preferred stock of Fiscal Management Co., Ltd.
Total .....	\$11,120,000	\$5,733,000

pation in all the profits and earnings of these organizations. As has been indicated, the vendors of control of these investment organizations were the holders of substantial blocks of common stock. These controlling individuals were therefore virtually operating large securities accounts which were "margined" with the funds supplied by the holders of the debentures and preferred stock. By the time that control was transferred, substantial losses had been sustained by these organizations and their security holders—losses which were sustained during the management periods of these vendors of control. Control was therefore transferred by these dominant individuals at a time when honest and competent management was required if the losses by the senior security holders and minority common stockholders were to be recouped.

In almost all of the investment companies discussed, the common stock, the largest blocks of which were held by the old managements, had no asset value, and the funds "belonged" substantially to the senior security holders, who did not possess, however, any vote or control over the funds. The obligation which was imposed upon the individuals transferring control either as sponsors, managers, directors, distributors of the securities or principal stockholders of the investment company, was intensified by the fact that the assets of these companies were for the most part cash or readily marketable securities, easily convertible into cash and were not subject to any investment restrictions. Yet the old managements and controlling stockholders, under these circumstances, transferred the funds of these public investors to groups of individuals without an effective investigation as to the character and ability of these individuals. The failure to make such investigation in view of the consequences attendant upon the transfer of these funds, is the outstanding fact which must affect the judgment of their conduct.

These managements not only received for their controlling blocks of stock prices far in excess of the asset or market value of these securities, but simultaneously relieved themselves of the burdens and obligations attendant on the management of other people's money. Although the old managements obtained these advantageous prices for their securities, they did not take any steps to notify the security holders of the contemplated transfer of control or to insure a continuance of the management and investment policies of the company in reliance upon which policies the public may have purchased or retained the securities of the investment companies. In fact, participation of the old managements in the transfer of control was not merely passive. They took affirmative steps to deprive the stockholders of the opportunity to elect their own directors. The old managements, who in several instances owned only a minority voting interest in their companies, actively facilitated the transfer of control by participating in a scheme of alternate resignation of the old directors and election of new directors. This device obviated any necessity for electing new directors at the next annual meeting of the stockholders or at a special meeting called for that purpose. By this scheme the security holders received no notice of the contemplated transfer of control, and were deprived of any opportunity to avail themselves in proper time of any legal remedy or recourse which they may have possessed to prevent the dissipation and depletion of their funds.

## X. GENERAL INVESTMENT CORPORATION

### (FORMERLY THE PUBLIC UTILITY HOLDING CORPORATION OF AMERICA)

#### A. Summary

General Investment Corporation (formerly The Public Utility Holding Corporation of America) was incorporated in Delaware on September 5, 1929, under the sponsorship of the United Founders Corporation group and The Harris Forbes Corporation (a subsidiary of Harris, Forbes & Company, a leading New York investment banking house), to invest in stock of public utility enterprises.

General Investment Corporation raised ultimately an aggregate of approximately \$78,634,000 by the issuance and resales of its securities. As of May 31, 1936, about two months prior to the date when control of General Investment Corporation was transferred by the sponsors to a new management, the investment company had sustained a loss in operations of approximately \$70,604,000, or 89½% of its paid-in capital.

The initial public distribution of the common stock of General Investment Corporation was started over-the-counter before its actual issuance on a "when issued" basis by the sponsors on September 6, 1929 (the day following the incorporation of the investment company). The opening "when issued" price for the stock was \$29 per share. By September 23, 1929, the sponsors had sold to the public, shares of common stock mainly on a "when issued" basis, at an average price of slightly in excess of \$26 per share, for an aggregate of approximately \$20,067,000. On September 16, 1929, when the "when issued" market price of its common stock was \$35-\$37 per share, as contemplated and agreed by its sponsors prior to its organization, General Investment Corporation issued to its sponsors 2,000,000 shares of its common stock and 500,000 shares of its class A common stock (multiple voting stock) all at \$12.50 per share, for an aggregate of \$31,250,000. The United Founders Corporation group then used part of this stock so issued to it by General Investment Corporation to make deliveries on the "when issued" commitments entered into with the public and realized a profit of approximately \$4,000,000 on these deliveries. In addition, the United Founders Corporation group received a \$500,000 commission on sales made directly by General Investment Corporation to the public.

From September 17, 1929, until the end of November 1929 the sponsors continued the public distribution of the common shares of General Investment Corporation at prevailing market prices, which were higher than the \$12.50 per share paid by the sponsors. On these sales, the sponsors, United Founders Corporation group and The Harris Forbes Corporation, realized an additional profit of \$2,254,000. As a result of this method of distribution, the United Founders Corporation realized a profit of \$5,280,000 and The Harris Forbes Corporation realized a profit of \$954,000 on the common stock of General Investment Corporation which they had resold to the public.

The two sponsors still retained 500,000 shares of Class A stock and 1,602,000 shares of common stock at a net cost of \$20,000,000 after deducting their profits on the resales. However, the cash investment of the United Founders Corporation group and of The Harris Forbes Corporation in the General Investment Corporation were further reduced when, on September 16, 1929, these sponsors sold directly to the investment company blocks of securities of utility companies for an aggregate of \$19,645,000 on which these sponsors realized an aggregate profit of about \$4,448,000. As a consequence, the United Founders Corporation group bettered its cash position by approximately \$2,700,000 and The Harris Forbes Corporation reduced its cash contribution for the General Investment Corporation stock to about \$3,000,000. However, the sponsors, by virtue of their ownership of the class A stock and the unsold portion of the common shares, still retained effective working control of General Investment Corporation, which ultimately had paid-in capital of \$78,634,000 and, at one time or another, participated in control of utility enterprises having aggregate resources of over \$811,500,000.

General Investment Corporation obtained approximately \$21,000,000 of its \$78,634,000 of total paid-in capital in September 1930 and thereafter through its acquisition of United States & Overseas Corporation in an exchange of stock.

United States & Overseas Corporation had been organized in January 1929 by The Harris Forbes Corporation, N. W. Harris & Co. of Chicago, the United Founders Corporation group, and Deutsche Bank und Discontogesellschaft, a bank in Germany, to lend intermediate credits to industrial and utility enterprises principally in Germany. By the beginning of September 1929, United States & Overseas Corporation had raised \$6,000,000 from the issuance of 600,000 shares of its stock to its original sponsors and certain other investment bankers. At that time, in contemplation of a public distribution of its securities, United States & Overseas Corporation reclassified its outstanding stock into 300,000 common shares and 300,000 Class A common shares; and issued to a distributing syndicate composed of the sponsors and headed by The Harris Forbes Corporation, an additional 450,000 shares of common stock at \$36 per share, for a total of \$16,200,000. These 450,000 shares, together with 150,000 common shares which the sponsors had previously purchased from the company at \$10 per share, were distributed publicly for \$35 per share for a total of \$21,000,000. Of this price, the company received \$17,700,000 and the sponsors received profits and distributing commissions of \$3,300,000. Beginning in September 1930, when the investment quality of the intermediate German credits in the portfolio of United States & Overseas Corporation had already become questionable, General Investment Corporation was caused to exchange about 273,000 shares of its \$3 dividend series preferred stock and 391,000 shares of its common stock, or an aggregate of about \$21,364,000 of its securities, for substantially all of the outstanding stock of the United States & Overseas Corporation. For the common shares of United States & Overseas Corporation (which had been for the most part distributed to the public), General Investment Corporation exchanged its stock on the basis of equivalent asset value and market value. However, for the United States & Overseas Corporation Class A common shares, which were held entirely by the sponsors of General Investment Corporation and of United States & Overseas Corporation and their associates, General Investment Corporation paid a substantial premium above asset value. In the subsequent liquidation of United States & Overseas Corporation, General Investment Corporation realized a loss of \$2,886,000, besides sustaining a loss of \$6,385,000 on intermediate German credits acquired from United States & Overseas Corporation.

General Investment Corporation, during its first management period, was caused by its sponsors to invest and reinvest an aggregate of approximately \$107,000,000 of its resources in securities of ventures in which these sponsors, particularly Harris, Forbes & Company, had a direct or indirect interest. General Investment Corporation, on these particular investments which were permeated with conflicts of interest, sustained losses aggregating approximately \$53,000,000 out of the total loss of \$70,604,000 sustained by the investment company during this management period.

Among the investments upon which the General Investment Corporation sustained substantial losses were the intermediate term German credits which were acquired by General Investment Corporation either directly from the Deutsche Bank, or indirectly by its acquisition of United States & Overseas Corporation, which had made the loans under the supervision of the Deutsche Bank, without exception, to clients of the bank. General Investment Corporation sustained a loss of \$3,156,900 on its \$7,750,000 participation in a \$15,000,000 debenture issue of Westphalia United Electric Company. The second largest loss on these German loans, ultimately aggregating over \$3,000,000, was sustained in connection with loans made to Elektrizitätswerke Suedwest, A. G., an electric-power company serving the city of Berlin. Almost all of this loss was sustained by General Investment Corporation on a \$3,107,000 participation in a syndicate headed by Deutsche Bank formed to lend Elektrizitätswerke Suedwest, through purchases of its debentures, funds to pay taxes to the city of Berlin. In the first half of 1930 United States & Overseas Corporation purchased, through Harris Forbes & Company, a participation of \$2,765,000 in a debenture syndicate at 112% of the face amount or \$3,107,000, of which \$1,840,000 in face amount were "ceded" to the investment company by Harris Forbes & Company. Harris Forbes & Company agreed to repurchase these \$1,840,000 of debentures on or before June 30, 1930. This repurchase obligation was extended to December 31, 1930, because the debentures had not been issued in marketable form by June 30, 1930. However, the management of United States & Overseas Corporation, controlled by Harris Forbes & Company, never formally made demand on Harris Forbes & Company to repurchase these debentures. Harris Forbes & Company contended that its obligation was to purchase from the investment company



debentures in marketable form and not to "repurchase the \$1,840,000 of debentures" which were "ceded." In August 1931 United States & Overseas Corporation sold the "loan" at cost to General Investment Corporation, which owned substantially all of the outstanding stock of United States & Overseas Corporation. Ultimately General Investment Corporation sustained a realized loss of approximately \$2,786,000 on this loan.

General Investment Corporation invested an aggregate of \$15,527,000 in securities of the Associated Gas and Electric Company system, a banking client of Harris Forbes & Company. General Investment Corporation bought, at the time of its formation in September 1929, \$9,081,000 of the Associated Gas and Electric Company system securities directly from the sponsors, who made a profit of about \$4,239,000 on this sale. General Investment Corporation acquired \$5,375,000 of these Associated Gas and Electric Company system securities at the end of September 1929, from Pynchon & Co., one of the bankers of the Associated system, by the issuance to these bankers of 145,270 shares of General Investment Corporation common stock. General Investment Corporation invested \$7,969,000 in the Associated Gas and Electric Company common stock alone, which had never theretofore paid a dividend and was apparently without underlying asset value at the time of acquisition. Of this amount \$3,000,000 was paid to The Harris Forbes Corporation for Associated Gas and Electric Company common stock which The Harris Forbes Corporation had received several years before as a bonus for becoming banker to the utility system. In addition, General Investment Corporation purchased from its sponsors for \$246,000 Associated Gas and Electric Company Class A common stock at an artificial market price, in part maintained by Harris Forbes & Company as agent for the Associated Gas and Electric Company system; \$423,000 of General Gas and Electric Corporation preferred stock which The Harris Forbes Corporation was currently distributing; and \$585,000 in Eastern Utilities Investing Corporation class A common stock, which was without asset value at that time. General Investment Corporation ultimately realized an aggregate loss of \$14,437,000 on these purchases, exclusive of the loss of United States & Overseas Corporation amounting to \$198,000 on its investments of \$460,000 in the Associated Gas and Electric Company system.

In September 1929, The Harris Forbes Corporation sold 95,000 common shares of the newly formed United States Electric Power Corporation for \$1,425,000 to General Investment Corporation and United States & Overseas Corporation at a profit of \$142,500. Ultimately the two investment companies sustained aggregate losses of \$849,550 on this investment.

The largest single investment and largest single loss of General Investment Corporation was in the stock of Central Public Service Company and its subsidiaries, for which system Harris, Forbes & Company was the banker. General Investment Corporation invested \$22,570,000 in the Central Public Service System, and lost approximately \$21,396,000. General Investment Corporation, at the time of its organization, purchased from The Harris Forbes Corporation not only a block of the common stock of Central Public Service Company, but also a block of Class A common stock of that company's subsidiary, Central Public Service Corporation, which The Harris Forbes Corporation was then distributing at artificially maintained prices. Thereafter, during the same month, General Investment Corporation acquired, in exchange for its own common stock, additional Class A stock from Albert E. Pierce & Company, the sponsor of the Central Public Service System, for an aggregate price of \$1,100,000.

The major part of the investment of General Investment Corporation in the Central Public Service System was acquired by an exchange of its control of Portland Electric Power Company pursuant to a contract dated January 30, 1930. The Portland company had been acquired by General Investment Corporation at a cost of \$19,035,000 in October 1929. It was sold to Central Public Service Corporation for \$8,221,000 cash, 175,000 shares Central Public Service Company common stock valued at \$4,200,000, and 300,000 shares Central Public Service Corporation Class A common stock valued at \$9,750,000. After this exchange, General Investment Corporation and Albert E. Pierce, sponsor and one of the bankers for the Central Public Service System, were the two largest stockholders in the system. By this exchange, Harris, Forbes & Company augmented the resources of the Central Public Service utility system, for which it was one of the bankers, by about \$90,000,000, increasing the total assets to \$364,000,000, or by about 33%. The price of \$9,750,000 for Central Public Service Corporation Class A stock acquired by General Investment Corporation was based on a market



artificially maintained for this stock. Between August 1929 and December 1929, Central Public Service Corporation, through Albert E. Pierce & Company and one of its own subsidiaries, bought in the market an amount of this stock equal to 70% of the total transactions in this stock on the New York Curb Exchange and the Chicago Stock Exchange; and the stock advanced about 65% in market price between October 29, 1929, and December 9, 1929. The \$4,200,000 of Central Public Service Company common stock acquired by General Investment Corporation had a current market value of \$3,255,000, and had never theretofore paid dividends.

The General Investment Corporation subsequently increased its investment in Central Public Service System to an aggregate of approximately \$22,500,000. In October 1935, the Central Public Service System was finally reorganized under Section 77B of the Bankruptcy Act. General Investment Corporation sustained an aggregate loss of approximately \$21,400,000, including a loss of about \$15,715,000, upon the sale of its block of Central Public Service Company common stock and Central Public Utility Corporation (successor to Central Public Service Corporation) Class A stock to Albert E. Pierce for \$70,000; and practically an entire loss of its investment of \$2,894,000 in American Commonwealths Power Corporation which went into receivership immediately after its acquisition by General Investment Corporation from Albert E. Pierce & Company in exchange for the Class A stock of Central Public Service Corporation.

In addition, General Investment Corporation lost its entire investment of \$967,000 in a participation in a \$5,000,000 syndicate headed by Harris Forbes & Company to finance acquisition of Washington Gas Light Company by the Central Public Service Company.

General Investment Corporation sustained a loss of \$7,251,000 in connection with its investment in South American Railways Company and Buenos Aires Central Railroad and Terminal Company. In 1929 the Terminal Company, a banking client of Harris Forbes & Company, had borrowed \$5,250,000 from a New York bank to finance temporarily construction of a subway in Buenos Aires. When the loan was made and later extended, Harris Forbes & Company had represented to the bank that it, Harris Forbes & Company, intended to distribute publicly a bond issue for the terminal company which would thus be provided with funds to repay the bank loan. However, after the market break in 1929, Harris Forbes & Company did not offer the bonds of the terminal company publicly but had General Investment Corporation organize South American Railways Company and had General Investment Corporation guarantee a \$12,000,000 note issue of South American Railways Company which Harris Forbes & Company distributed to the public. The proceeds of this issue were loaned by South American Railways Company to the terminal company which used the funds to repay the bank loan and complete the construction of the subway. Eventually the terminal company defaulted on its obligation to pay the loan from South American Railways Company, and General Investment Corporation was compelled to purchase for approximately \$9,882,000 the \$12,000,000 of South American Railways Company notes which had been sold, with the guarantee of General Investment Corporation, to the public. On the resale of its entire investment in this venture, which aggregated approximately \$14,316,000, General Investment Corporation sustained a loss of about \$7,251,000.

By May 31, 1936, the investment company, having sustained a shrinkage of \$73,000,000 in its capital, had assets on the basis of book values of only \$5,400,000. In August of 1936, control of General Investment Corporation was sold to International Equities Corporation, an investment company controlled by Ernest B. Warriner. The funds necessary to purchase control of International Equities Corporation had been furnished Ernest B. Warriner by one Wallace Groves. General Investment Corporation was caused to purchase from its parent, International Equities Corporation, controlled by Mr. Warriner, a \$1,000,000 participation in the preferred stock of Certain-teed Products Corporation, a company in which Wallace Groves was indirectly interested through his Phoenix Securities Corporation.

In November 1936 General Investment Corporation sold its investment in the Terminal Company to a governmental agency of the Argentine for approximately \$7,500,000, consisting of approximately \$5,750,000 in cash and \$1,750,000 in a subparticipation in a syndicate loan. A "commission" of \$250,000 was paid to Philip Deronde, an associate of Wallace Groves, although the negotiations had been theretofore substantially completed by one Mr. Billings, to whom a com-

mission of only \$35,000 was paid. From the balance of the cash proceeds of the sale of the notes there was disbursed by General Investment Corporation \$2,508,282, used to purchase 24,591 shares of the company's outstanding preferred stock at \$102 per share from Wallace Groves, who had simultaneously acquired 20,731 shares at \$87.50 per share, and 3,860 shares at \$100 per share, thus realizing by these transactions a profit of \$308,320.

During December 1936 General Investment Corporation was caused to buy for \$641,000 from Phoenix Securities Corporation, controlled by Wallace Groves, a block of stock of Standard Investing Corporation, which Phoenix Securities Corporation had acquired in an unsuccessful attempt to wrest control of Standard Investing Corporation from Brown Brothers, Harriman & Company, an investment banking firm. As a result of these transactions, a major part of the \$5,750,000 of cash received by General Investment Corporation by the sale of its Terminal Company notes was disbursed in transactions in which Wallace Groves, companies in which he had substantial interest, or his associates, were pecuniarily interested. General Investment Corporation resold its investment in Standard Investing Corporation to Henderson Brothers of Boston, and two weeks later Standard Investing Corporation purchased the control block of stock of International Equities Corporation from Mr. Warriner at a profit of \$1,860,000 to Mr. Warriner. After Henderson Brothers succeeded to control, General Investment Corporation invested a substantial amount of its funds in real estate.

## B. Organization and Capitalization of General Investment Corporation

General Investment Corporation was incorporated in Delaware on September 5, 1929, as The Public Utility Holding Corporation of America, under the sponsorship of The Harris Forbes Corporation, and United Founders Corporation and its affiliate, American Founders Corporation.<sup>1</sup> The purposes and powers of the corporation were both those of an investment company and a holding company<sup>2</sup> but Harris Forbes & Company<sup>3</sup> on whom the United Founders Corporation group

<sup>1</sup> Public Examination, American General Corporation, et al., Commission's Exhibit No. X3423 (p. 1). On July 21, 1933, the name of the company was changed to General Investment Corporation. (Id., Commission's Exhibit No. X3423-1.)

<sup>2</sup> Ibid.

<sup>3</sup> Harris Forbes & Company was an outgrowth of N. W. Harris & Co. which was a partnership formed in Chicago in 1880 to engage in the investment-banking business. In 1912, N. W. Harris & Co. was incorporated under the name of the Harris Trust and Savings Bank in Chicago. At that time a holding company, Harris Forbes Companies, was formed and Harris Forbes & Company and Harris Forbes & Co., Inc., two operating subsidiaries, were established to do business in New York and Boston, respectively. By 1926, Harris Forbes & Company was one of the leading New York investment-banking houses. It also became a distributor of common stocks and in this connection formed a subsidiary, The Harris Forbes Corporation. During 1928 and 1929, the Harris Forbes group of companies handled a larger volume of public financing than any other investment-banking organization in the United States.

Among the stockholders of Harris Forbes Companies who also became directors of General Investment Corporation were C. W. Beall, E. C. Granbery, Harry M. Addinsell, F. S. Burroughs, W. E. McGregor, Don C. Wheaton, George D. Woods, M. H. MacLean and Adolphe Wenzell.

In the summer of 1930, Harris Forbes Companies was sold to Chase Securities Corporation and the Chase National Bank. During the following year there was a merger of the investment-banking business of the Harris Forbes group of companies with that of the Chase Securities Corporation under the name of Chase Harris Forbes Corporation. In the spring of 1933, the investment-banking business of Chase Harris Forbes Corporation was liquidated and thereafter, the Chase National Bank divested itself of the Chase Securities Corporation, by distributing the shares to its own stockholders after first changing the name from Chase Securities Corporation to Amerex Holding Corporation. After the purchase of Harris Forbes Companies by the Chase Securities Corporation in 1930, the latter was represented on the board of the investment company by Murray W. Dodge and

relied for the management of General Investment Corporation,<sup>4</sup> and which controlled The Harris Forbes Corporation intended to cause General Investment Corporation to invest in the equity securities of public utility companies, particularly those which Harris, Forbes & Company had theretofore been financing.<sup>5</sup>

In all, General Investment Corporation received \$76,334,431.45 proceeds from the original issue of its capital stock, as follows:<sup>6</sup>

Security	Shares	Proceeds
Cumulative preferred, \$3 dividend series—later changed to \$6 dividend series.	254,026	\$14,606,506.50
Common.....	3,143,744	55,227,924.95
Class A common.....	500,000	6,250,000.00
Free warrants.....	50,000	250,000.00
Total.....		76,334,431.45

In addition, General Investment Corporation received \$2,299,976.12 contributed capital surplus by reason of the resale of treasury shares at an excess of \$1,979,079.80 over the cost thereof<sup>7</sup> and by reason of the retirement of part of its gold notes<sup>8</sup> at a \$320,896.32 discount,<sup>9</sup> this increasing the contribution<sup>10</sup> to the investment company to \$78,634,407.57. Of this, \$5,530,845.46 was returned to stockholders

Frank Callahan, as well as by the director previously identified with Harris Forbes Companies.

At the time of the sale of Harris Forbes Companies to Chase Securities Corporation, one-half of The Harris Forbes Corporation was acquired by Chase Securities Corporation, and one-half by the old stockholders of Harris Forbes Companies. At that time the name of The Harris Forbes Corporation was changed to Public Utility Associates, Inc. Ultimately, in 1935 and 1936, Public Utility Associates, Inc., was acquired by the United Founders Corporation group of investment companies and its successor, American General Corporation, and was liquidated.

Harris Forbes & Company first became associated with the United Founders Corporation group of investment companies in 1924 and 1925 through its sales department. In June 1927 Harris Forbes & Company distributed a \$15,000,000 debenture issue for International Securities Corporation of America, one of the members of the United Founders Corporation group of companies. Thereafter two representatives of Harris Forbes & Company served as directors of almost every company of the United Founders Corporation group. (Id., at 23109-11, 23144-9, 25292-6, and Commission's Exhibit No. X3424 (p. 16); also Public Examination, Eastern Utilities Investing Corporation, Commission's Exhibit No. 3845-d.)

<sup>4</sup> Op. cit. supra, note 1, at 26320-1.

<sup>5</sup> Id., at 25114-15.

<sup>6</sup> Id., Commission's Exhibit No. X3424 (pp. 12, 13).

<sup>7</sup> Id., Commission's Exhibit No. X3424 (pp. 13, 23, and 24).

<sup>8</sup> Id., Commission's Exhibits Nos. 3423A-A16, X3996, and X3998: These notes were issued to retire part of an issue of \$12,000,000 notes of South American Railways Company, a subsidiary of General Investment Corporation which had previously issued its notes guaranteed by General Investment Corporation and convertible into the common stock thereof.

<sup>9</sup> Id., Commission's Exhibit No. X3423A-A16.

<sup>10</sup> "Contribution" to the investment company and "contributed capital" are used throughout to mean the amount paid into the company in cash or property for the capital securities of the investment company and not in the sense of gratuitous donations. Although technically the discount on the notes retired did not constitute contributed capital it was part of the net contribution by the security holders of the company for the securities thereof.

in cash or securities as cash dividends paid on its capital stock and in payment for capital shares repurchased.<sup>11</sup> This left net contributed capital of \$73,103,562.11.

By August 1936, when control of General Investment Corporation was transferred to Ernest B. Warriner<sup>12</sup> the assets, as shown in the company's annual report of May 31, 1936, had shrunk to about \$5,418,000, indicating realized and unrealized losses of approximately \$70,604,000 at that time.<sup>13</sup>

Although General Investment Corporation received net contributed capital of \$73,103,562.11 at the time the enterprise was conceived in August 1929,<sup>14</sup> no public participation was contemplated but rather a joint venture by the Harris Forbes interests and the United Founders Corporation group was intended.<sup>15</sup> In this connection F. S. Burroughs, the president of the investment company,<sup>16</sup> testified:<sup>17</sup>

Q. Whose idea was it to have The Public Utility Holding Corporation [General Investment Corporation]?

A. I think it was mine primarily.

Q. How did the American Founders happen to get into the picture—the Founders Group?

A. Well, I think it developed from conversations between Mr. Devendorf and myself and I think Mr. Devendorf sold his associates on the idea and I sold my associates on the idea of a jointly owned investment company to participate in enterprises both domestic and foreign, and we did not have any thought of offering any of our stock to the public. We thought of it as a company that would be owned roughly half by Harris Forbes and the individuals of Harris Forbes and the other half by the Founders and possibly individuals identified with the Founders.

However, the idea of a private venture was short lived because the management of the United Founders Corporation group of investment companies<sup>18</sup> desired a public market for any substantial invest-

<sup>11</sup> Id., Commission's Exhibit No. X3424 (pp. 11-15 and 23-26).

<sup>12</sup> Public Examination, General Investment Corporation, Commission's Exhibit No. 1565.

<sup>13</sup> See *infra*, p. 584.

<sup>14</sup> Op. cit. *supra*, note 1, at 26319.

<sup>15</sup> The original certificate of incorporation of General Investment Corporation authorized 200 shares of common stock of which 100 shares were designated Class A, the holders thereof being entitled to a vote equal to 40% of the entire voting power of the stockholders of the Corporation, regardless of the number of shares of each class of stock outstanding. In addition, the charter authorized the issuance of no-par-value preferred stock in amounts and with preferences to be determined at the time of issuance by the company's directors. (Id., Commission's Exhibit No. X3423-I.)

<sup>16</sup> Id., at 25295 and Commission's Exhibit No. X3424 (p. 16): Mr. Burroughs was one of the principal executives of Harris, Forbes & Co. and served as president of General Investment Corporation from its inception until June 1932.

<sup>17</sup> Id., at 25409.

<sup>18</sup> This group of investment companies hereafter sometimes referred to as the "Founders Group" consisted principally of United Founders Corporation, American Founders Corporation, International Securities Corporation of America, Second International Securities Corporation, United States & British International Company, Ltd., American & General Securities Corporation, Founders General Corporation, and the following affiliated investment companies: American and Continental Corporation, North and South American Corporation, International and General Corporation, United States Electric Power Corporation, United National Corporation (Seattle) and Investment Trust Associates. (Id., Commission's Exhibit No. X3424 at p. 4.)

ment that their companies might make. In this respect Mr. Burroughs testified:<sup>19</sup>

Q. But about the time of the incorporation you had lost this notion of having a privately owned company, had you not?

A. As I remember it, the Founders people took the position that it was not appropriate for them to have a large investment in any enterprise where the securities did not have a quoted market and they wanted to put enough of the stock out with the public so that it would have some outside market that they could use in evaluating their holdings; but at the outset I do not think there was any stock sold to outsiders except some that the Founders wanted to pass on direct to dealers that were active in their securities.

Accordingly it was originally contemplated that a block of General Investment Corporation common stock not in excess of 500,000 shares would be distributed to the public for about \$5,000,000 proceeds to the issuing company.<sup>20</sup> However, proceeds of the initial distribution to the public far exceeded this amount. The 500,000 shares which were intended originally to be sold for \$5,000,000 were sold to the public for approximately \$12,700,000.

### C. Issues and Distribution of Securities

#### 1. SUMMARY OF ORIGINAL DISTRIBUTION—ADVANTAGES TO THE SPONSORS BY REASON OF THEIR PARTICIPATION IN THE FORMATION OF GENERAL INVESTMENT CORPORATION AND IN THE INITIAL SALES OF ITS SECURITIES TO THE PUBLIC

As will be discussed hereafter in detail, the initial distribution of common stock of General Investment Corporation ended in November 1929. By that time, 2,877,066 shares of common stock and 500,000 shares of Class A common stock (differing from the ordinary common stock only in that it had multiple voting power<sup>21</sup>) had been issued by General Investment Corporation for an aggregate of \$56,348,101.33.<sup>22</sup> Of this stock, General Investment Corporation had issued 500,000 Class A shares and 2,000,000 common shares to the sponsors for \$31,250,000 for their own account and 600,000 common shares to the sponsors for public distribution, which latter sale realized \$14,912,830 net proceeds for the investment company after a \$550,000 distributing commission. The remaining 277,066 shares were issued to or through dealers in exchange for securities valued at \$10,185,271.53.<sup>23</sup> However, by November 1929 the sponsors had resold 397,128 common shares of the block held by them to the public for

<sup>19</sup> Id., at 25410-11.

<sup>20</sup> Id., at 25412.

<sup>21</sup> Id., Commission's Exhibit No. X3423-I. The holders of the Class A common stock were entitled to cast a vote equal to 66⅔% of the number of shares of common stock outstanding, the holders of which were entitled to one vote per share.

<sup>22</sup> Id., Commission's Exhibit No. X3424 (p. 12).

<sup>23</sup> Ibid.

\$11,199,287.50,<sup>24</sup> and in addition had sold portfolio securities to General Investment Corporation at a profit to the sponsors of at least \$4,448,235.71.<sup>25</sup> As a result, when the organization of the investment company and the original distribution of its securities were completed, the sponsors retained an aggregate of 500,000 shares of Class A stock and 1,602,872 shares of common stock of General Investment Corporation or in excess of a 62% interest in the investment company which cost them \$15,052,476.79 net,<sup>26</sup> whereas the public stockholders held 1,274,194 shares of common stock of General Investment Corporation, or less than a 38% interest in the investment company at a cost of \$36,847,388.83.<sup>27</sup>

As heretofore indicated, the principal contribution of capital to General Investment Corporation was \$55,227,924.95 proceeds from the issue of 3,143,744 shares of common stock. The issue and distribution of these shares are summarized in Table 3.<sup>28</sup>

The 500,000 shares Class A common stock, of which 250,000 shares were sold to The Harris Forbes Corporation and 250,000 shares to the United Founders Corporation group, were issued on September 16, 1929, at \$12.50 per share, or a total of \$6,250,000.<sup>29</sup> The 254,026 shares of cumulative preferred \$3 dividend series shares were issued, starting in September 1930, for \$14,606,506.50<sup>30</sup> in connection with the acquisition of United States & Overseas Corporation at a cost of \$21,364,532.88.<sup>31</sup>

#### a. Sale of Portfolio Securities by Sponsors to General Investment Corporation at Its Inception at a Profit of \$4,448,000

The initial issue of stock of General Investment Corporation consisted of the 500,000 shares of Class A common stock and 2,000,000 shares of common stock issued to the United Founders Corporation group and The Harris Forbes Corporation at \$12.50 per share for \$31,250,000.<sup>32</sup> Within a week, however, General Investment Corporation purchased securities of public-utility companies at their market value of \$19,645.655—\$13,277,908.20 thereof were received from the United Founders Group and \$6,367,757.65 from The Harris Forbes

<sup>24</sup> See Table 3, *infra*.

<sup>25</sup> See notes 33 and 251, *infra*.

<sup>26</sup> This figure is derived by subtracting from the \$31,250,000 subscription paid to General Investment Corporation by the sponsors, the \$11,199,287.50 proceeds received by them from the resale of 397,128 of their common shares, the \$550,000 commission paid to them on the public distribution of 600,000 shares and the \$4,448,235.71 profit which the sponsors made by selling portfolio securities to General Investment Corporation.

<sup>27</sup> This figure includes the 600,000 shares distributed for the investment company for \$15,462,830 (including commission), the 397,128 shares which the sponsors resold to the public for \$11,199,287.50, and the 277,066 shares issued to or through dealers for securities valued at \$10,185,271.33.

<sup>28</sup> Unless otherwise indicated, the data set forth appear in Commission's Exhibit No. X3424 (pp. 12, 13, 32-34).

<sup>29</sup> *Id.*, Commission's Exhibit No. X3424 (p. 12).

<sup>30</sup> *Id.*, Commission's Exhibit No. X3424 (pp. 12-13).

<sup>31</sup> *Id.*, Commission's Exhibit No. X4111.

<sup>32</sup> *Id.*, Commission's Exhibit X3424 (p. 12).

TABLE 3.—*General Investment Corporation—Schedule of issuance and distribution of common stock*

		Price	Common shares issued	Proceeds received by issuers	Price	Common shares issued	Proceeds received by issuers
Sept. 1 <sup>c</sup> , 1929.....	Shares sold for cash: To United Founders Group..... Less: Shares resold by the United Founders Group publicly between Sept. 16 and Nov. 30, 1929, through Founders General Corporation for proceeds of \$9,406,609.25, a profit of \$5,280,089.25.....	\$12.50	1,350,000	\$16,875,000.00			
	Shares retained by the United Founders' Group.....						
Sept. 16, 1929.....	To The Harris Forbes Corporation..... Less: Shares resold by The Harris Forbes Corporation publicly between Sept. 16 and Nov. 30, 1929, through Founders General Corporation for proceeds of \$1,792,678.25, a profit of \$954,378.25.....	12.50	650,000	8,125,000.00	\$12.50	1,019,936	\$12,749,200.00
	Shares retained by The Harris Forbes Corporation.....	12.50	* 67,064	<sup>b</sup> 838,300.00			
Sept. 16-Nov. 30, 1929.....	Shares sold to sponsors (net) for cash and proceeds received by General Investment Corporation.....				12.50	582,936	7,286,700.00
Sept. 17, 1929.....	Sold publicly by sponsors through Founders General Corporation for cash as indicated above*.....					1,602,872	20,035,900.00
Nov. 27, 1929.....	Sold publicly through Founders General Corporation for cash (less commission of \$500,000).....				12.50	*397,128	4,964,100.00
Mar. 19, 1930.....	Sold publicly through Founders General Corporation for cash (less commission of \$50,000).....				24.47	500,000	12,237,830.00
	Sold publicly through Albert E. Pierce & Co. for cash <sup>e</sup> .....				26.75	100,000	2,675,000.00
					20-22	134,372	2,756,184.00
	Shares sold publicly for cash and proceeds received by General Investment Corporation.....					1,131,500	22,633,114.00
	Total shares sold for cash and proceeds received by General Investment Corporation.....					2,734,372	42,669,014.00
	Shares issued in exchange for portfolio securities:						
Sept.-Nov. 1929.....	Exchanged with Albert E. Pierce & Co., Potter & Co., E. W. Clark & Co., and Pynchon & Co.....					277,066	10,185,271.53
Jan.-May 1930.....	Exchanged, largely with Potter & Co.....					27,706.4	695,660.90
Aug. 5-Sept. 14, 1931.....	Exchanged with Potter & Co. for shares of Cuba Co.....					104,310	1,668,960.00
Oct. 1, 1931.....	Issued in connection with the United States & Overseas Corporation exchange.....					225	4,756.50
	Total shares issued in exchange for portfolio securities <sup>d</sup> .....					409,307.4	12,554,648.93
	Sundry.....					64.6	4,262.02
	Total common shares issued and proceeds received by General Investment Corporation.....					3,143,744	55,227,924.95

<sup>a</sup> Id. Commission's Exhibit No. X3979.

<sup>b</sup> Id. Commission's Exhibit No. X4098.

<sup>c</sup> Albert E. Pierce & Co., Inc., was a Chicago investment banking enterprise identified with the sponsorship of various utility enterprises, notably the Central Public Service System and is not to be confused with the New York Stock Exchange firm of E. A. Pierce & Co., an entirely unrelated enterprise. The further relationship of Albert E. Pierce & Co. to General Investment Co. is discussed infra.

<sup>d</sup> These 409,307 shares General Investment Corporation common were exchanged for the following:

Common shares delivered	Exchanged for shares of--	Shares received	Amount	Exchanged with or through--
104,310	Cuba Co.	104,310 common	\$1,068,960.00	Potter & Co.
225	U. S. & Overseas Corporation		4,756.50	
1 57,450	Indiana Consumers Gas & By-Products Co.	99,900 common	1,766,250.00	Potter & Co.
	Portland Electric Power Co.	1,132 prior pfd	116,370.44	E. W. Clarke & Co.
	Portland Electric Power Co.	10 first pfd	1,027.71	E. W. Clarke & Co.
47,165	Portland Electric Power Co.	20,079 d pfd	1,577,534.08	E. W. Clarke & Co.
	Portland Electric Power Co.	25,449 common	36,256.20	E. W. Clarke & Co.
	Associated Gas & Electric Co.	25,000 common	1,500,000.00	Pyncheon & Co.
145,270	Associated Gas & Electric Co.	50,000 dep. wts	1,250,000.00	Pyncheon & Co.
	General Gas & Electric Corporation	25,000 class A	2,624,990.00	Pyncheon & Co.
	American Commonwealth Power Corporation	8,197 class A	235,663.00	A. E. Pierce & Co.
38,943	American Commonwealth Power Corporation	558 class B	27,342.00	A. E. Pierce & Co.
15,944	Central Public Service Corporation	20,000 class A	1,100,000.00	A. E. Pierce & Co.
	Miscellaneous		645,499.00	
409,307	Total		12,554,648.93	

<sup>1</sup> Plus cash.



Corporation.<sup>33</sup> As a consequence, the cash cost of the General Investment Corporation stock to the sponsors was immediately reduced by the sale of these securities to the investment company.

From the sales the United Founders Corporation group realized profits of \$1,448,235.71<sup>34</sup> and The Harris Forbes Corporation a profit of at least \$3,000,000.<sup>35</sup> The sale of these securities by the sponsors to General Investment Corporation was contemplated prior to its organization.<sup>36</sup> In this connection Mr. Burroughs, president of General Investment Corporation testified:<sup>37</sup>

Q. \* \* \* Now you recall that early in September or shortly after the formation of the company securities were sold by Harris Forbes Corporation and by Founders into The Public Utility Holding Corporation [General Investment Corporation]?

A. Oh, yes. That was all arranged between the group that organized the company prior to the actual formation. In other words, when we formed the company it was the understanding among the organizers that Founders and Harris Forbes and any of the individuals might turn in certain appraised securities at the then market value in payment for their subscription. Whether

<sup>33</sup> Id., Commission's Exhibits Nos. X3969 and X3980: The securities sold to General Investment Corporation by Harris Forbes & Co. and companies in the United Founders Corporation group from September 13, 1929, to September 16, 1929, may be summarized as follows:

Name of security	Total		Purchased from Harris Forbes & Co.		Purchased from United Founders Group		
	Number of shares or par value	Cost to General Investment Corporation	Shares	Proceeds	Shares	Proceeds	Profits
Associated Gas & Electric Co.:							
Common.....	107,644	\$6,469,835.51	51,144	\$3,075,033.01	56,500	\$3,394,802.50	\$828,516.24
Class "A".....	3,526	246,820.00	3,526	246,820.00			
Rights.....	1,000	29,980.00			1,000	29,980.00	11,230.00
Debenture rights.....	59,400	1,246,700.00	24,400	511,400.00	35,000	735,300.00	357,507.50
Debentures "A" 6-1999.....	57,350	79,360.00	57,350	79,360.00			
Central Public Service Co.: Common.....	10,600	741,996.00	10,000	700,020.00	600	41,976.00	20,686.00
Central Public Service Corporation: Class "A".....	10,100	506,225.00	10,100	506,225.00			
Eastern Utilities Investing Corporation: Common "A" X rights.....	21,000	585,375.00			21,000	585,375.00	17,781.40
General Gas & Electric Corporation: \$6 preferred.....	4,000	423,000.00			4,000	423,000.00	24,800.00
Total.....		10,329,291.51		5,118,858.01		5,210,433.50	1,260,521.14
Other securities.....		*9,316,374.34		*1,248,899.64		8,067,474.70	187,714.57
Grand total.....		19,645,665.85		6,367,757.65		13,277,908.20	1,448,235.71

\* Securities sold to General Investment Corporation for approximately \$136,000 are included in the above figure of \$1,218,899.64 as having been sold by Harris Forbes & Co., although it is not definitely known that these securities come from this or some other source.

<sup>34</sup> See note 33.

<sup>35</sup> See note 251, *infra*.

<sup>36</sup> The more substantial losses suffered by General Investment Corporation on the portfolio securities so acquired from its sponsors will be discussed later. See Table 5, p. 534.

<sup>37</sup> Op. cit. *supra*, note 1, at 25445.

that was done immediately or whether it was after a delay of a week or two I don't recall, but I know perfectly well that the bulk of the subscription was actually paid off with securities.

By this sale The Harris Forbes Corporation disposed of substantially all of its portfolio of public utility securities to General Investment Corporation. Mr. F. S. Burroughs testified:<sup>38</sup>

Q. Mr. Burroughs, did you put in all the public-utilities securities that you owned and that Harris Forbes owned?

A. I think substantially all that The Harris Forbes Corporation held. I believe we put in substantially all of them. In fact, Mr. Stern, so far as Harris Forbes Corporation's own portfolio is concerned, we really looked on The Public Utility Holding Corporation as taking partners into our own portfolio so that we, in effect, turned our portfolio over to the corporation and took stock for it. That is really what Harris Forbes Corporation did and, in addition, paid in some cash.

Q. After Harris Forbes Corporation took Public Utility Holding Corporation stock was that all it held from that time until Harris Forbes became the Public Utility Associate?

A. \* \* \* You mean was that its primary investment?

Q. Yes: was that its primary investment?

A. Yes.

In only one of the circulars issued in connection with the public distribution of securities of General Investment Corporation was this fact disclosed. In a circular dated September 9, 1929, it was stated that:<sup>39</sup>

The corporation will acquire from its organizers certain minority interests in a diversified group of domestic public utility companies.

Nevertheless, even this circular did not disclose the extent of the profit realized by the sponsors in the sale of portfolio securities to the investment company nor that nearly one-half of the dollar amount of the securities acquired by the investment company from its sponsors were those of the Associated Gas and Electric Company and its affiliated companies, for which Harris Forbes & Company were the bankers.

Moreover, the sale of these securities by the sponsors to General Investment Corporation was subjected to no independent scrutiny and appraisal of their investment value. The entire directorate of General Investment Corporation which approved the purchase of the securities was composed only of representatives of The Harris Forbes Corporation and of the United Founders Corporation group, both of which were pecuniarily interested in the transaction.<sup>40</sup> Mr. F. S. Burroughs, a member of Harris Forbes & Company and the first president of General Investment Corporation, conceded that a duality of interest of this type was undesirable in the management of investment companies. Mr. Burroughs testified:<sup>41</sup>

<sup>38</sup> Id., at 25447-8.

<sup>39</sup> Id., Commission's Exhibit No. X3978.

<sup>40</sup> Id., Commission's Exhibit No. X3978 (p. 3). The initial board of directors of the company consisted of H. M. Addinsell, C. W. Beall, Frederick S. Burroughs, E. C. Granbery, W. E. MacGregor, D. C. Wheaton, and M. H. MacLean, all stockholders of Harris Forbes & Company; Lawrence V. Carron, George E. Devendorf, E. Stanley Glines, and Louis H. Seagrave, all officers of the United Founders Corporation group. See note 3 *supra*, also Commission's Exhibit No. X3762.

<sup>41</sup> Id., at 25586-7.

A. \* \* \* I think it is too difficult for any human being to be sure that he is protecting both classes of investors. I think he may be perfectly honest in his effort to be sure that he is dealing fairly with the investment trust but I don't think it is possible for him to do it and I think it is a bad idea for investment bankers to have an investment trust affiliate.

Q. And in more general terms, the same thing would apply to any management who was in a position of having two companies and controlling both, and having them transact security sales back and forth?

A. It is always difficult to be sure that your transactions five years hence will look as good as they do at the time you make them. And it is just too hard. I think it is wrong. I don't think it is possible for people to maintain their balance and keep the two entirely separate. I think that is the way it is worked out. I don't think that most of the bad experience which has happened to all this class of situations was because of any dishonesty of intent but I think it was impossible for the investment banker that formed these investment trusts to use the same kind of judgment that they would have used if they had been only interested in investment trusts. I don't think there is any doubt about that.

The remaining common stock issued by General Investment Corporation for cash during September 1929 was a block of 500,000 shares issued to Founders General Corporation for \$12,237,830 on September 17, 1929, in connection with the public distribution of the securities.<sup>42</sup>

#### b. Public Distribution of General Investment Corporation Common Stock at \$6,234,000 Profit to Sponsors—Nondisclosure of Profit

On September 5, 1929, a news story of the formation of General Investment Corporation was published in *The New York Times*.<sup>43</sup> The public distribution was initiated on September 6, 1929,<sup>44</sup> without any prospectus or selling circulars.<sup>45</sup>

The initial distribution of General Investment Corporation's common stock was to have been made by The Harris Forbes Corporation; but, on September 5, 1929, when General Investment Corporation was formed, The Harris Forbes Corporation felt that it was not equipped to handle the distribution at that time.<sup>46</sup> Instead, The Harris Forbes Corporation turned its customers' and dealers' lists

<sup>42</sup> See Table 3, *supra*, p. 506.

<sup>43</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. X3962. *The New York Times* article stated: "Wall Street interpreted the news of the formation of the new trust as likely to provide support for Associated Gas and Electric shares, which rose more than 3 points to a new high record of 70 yesterday. This was due to the fact that Harris Forbes interests have been for some time bankers of the Associated group, the premise being that they would back their own interest."

<sup>44</sup> On September 6, 1929, Founders General Corporation, the distributing company of the United Founders Corporation group (*id.*, at 22685) was selling common shares of General Investment Corporation to dealers over-the-counter on a "when as and if issued" basis. (*Id.*, Commission's Exhibits Nos. X3934, X3935, and X3977.)

<sup>45</sup> On September 9, 1929, a circular entitled "Advance Information The Public Utility Holding Corporation of America, Common Stock" was published, reciting that the corporation was being organized (*id.*, Commission's Exhibit No. X3978).

The first printed circular was published on or after September 23, 1929, after the issuance of 500,000 shares of Class A common stock and 2,684,213 shares of common stock for assets of "more than \$50,000,000." (*Id.*, Commission's Exhibit No. X3978.)

<sup>46</sup> *Id.*, at 26318.

over to Founders General Corporation <sup>47</sup> which in turn, on September 16, 1929, entered into an agency contract with General Investment Corporation, agreeing to use its best efforts to distribute 500,000 common shares for the investment company at a commission of \$1 per share, and agreeing to account to the investment company for the proceeds of the distribution.<sup>48</sup>

As heretofore indicated <sup>49</sup> by the end of November 1929 Founders General Corporation distributed publicly a total of 997,123 common shares of General Investment Corporation for \$26,661,397.50, of which 600,000 shares were distributed on behalf of General Investment Corporation for \$14,912,820 net after \$550,000 commissions paid to Founders General Corporation, and of which 397,128 shares were redistributed on behalf of the sponsors for \$11,199,287.50, a profit to them of \$6,234,467.50 over the \$4,964,100 paid by them to the investment company. In other words, as a result of the initial public distribution ending November 1929, of every \$26 raised through the public sale of the General Investment Corporation stock by the sponsors,<sup>50</sup> over \$6 was retained by them as a profit. However, the offering circular did not even indicate that the sponsors were reselling for their own account the shares of General Investment Corporation owned by them as well as new stock issued by the investment company.<sup>51</sup>

c. \$56 250 000 Discount from the Market Price in the Issue Price at Which Its Shares Were Issued to Sponsors by General Investment Corporation

The \$6,234,467.50 profit received by the sponsors on the resale of these shares costing them \$4,964,100 was only part of the \$56 250,000 discount from the market in the price at which they were permitted

<sup>47</sup> Id., at 25617. Founders General Corporation was a wholly owned subsidiary of the United Founders Corporation group. (Id., at 26318, 22085.) Founders General Corporation distributed the General Investment Corporation common stock for about one month, and thereafter The Harris Forbes Corporation handled the distribution (id., at 26318).

In 1930, Albert E. Pierce & Company handled the public distribution of General Investment Corporation's common stock. (Id., Commission's Exhibit No. X4103.)

<sup>48</sup> Id., Commission's Exhibit No. X3423-3-C.

<sup>49</sup> See Table 3, *supra*, p. 506.

<sup>50</sup> The distribution of the General Investment Corporation shares was made by Founders General Corporation and The Harris Forbes Corporation as well. Founders General Corporation recorded in an account entitled "Harris Forbes Syndicate account" sales by the end of November 1929 of 1,525,788 shares for \$45,688,598.91. (Id., Commission's Exhibit No. X3875.) During the same period, Founders General Corporation purchased from the United Founders Corporation group 330,064 shares for \$9,406,609.25 (id., Commission's Exhibit No. X3979) and directly from General Investment Corporation 500,000 shares for \$12,237,830. (Id., Commission's Exhibit No. X3875.) An additional 693,448 shares purchased for \$23,319,964.17 (ibid.) included 100,000 shares purchased from General Investment Corporation in November 1929 for \$2,675,000 (id., Commission's Exhibit No. X4098), 89,813 shares accumulated net by The Harris Forbes Corporation in support of the market at the \$2,991,678.94 cost thereof to Harris Forbes, and 67,064 shares bought from The Harris Forbes Corporation for \$1,792,678.25 (ibid.) and 422,412 shares bought in the market for \$15,594,179.23. The Harris Forbes Corporation itself sold during the period 127,370 shares for \$4,262,233.26 and bought in the market 217,183 shares for \$7,253,912.20, leaving it with an accumulated balance of 89,813 shares costing \$2,991,678.94 which it turned over to Founders General Corporation as heretofore indicated (ibid.)

<sup>51</sup> Id., Commission's Exhibit No. X3978.

to buy the shares. On September 16, 1929, the sponsors, pursuant to an unwritten agreement of the sponsors made prior to the organization of General Investment Corporation,<sup>52</sup> purchased from General Investment Corporation the initial issue of 2,000,000 shares of common stock and 500,000 shares Class A common stock, which had all the rights of the common stock but had in addition multiple voting power, at \$12.50 per share for a total of \$31,250,000.<sup>53</sup> This purchase was effected 10 days after Founders General Corporation had initiated the distribution of the General Investment Corporation common stock at a price of \$29 per share.<sup>54</sup> At the time of the issue of these shares to the sponsors the current market price of the stock was \$35 to \$37 per share<sup>55</sup> or approximately \$87,500,000 for the 2,500,000 shares sold to the sponsors for \$31,250,000.

According to Mr. Burroughs, this technique of distributing the stock first and permitting the sponsors to subscribe for it later was both "unusual" and indefensible:<sup>56</sup>

Q. Mr. Burroughs, you have been a director of a great many corporations?

A. Yes, sir.

Q. Do you know of any case in which a corporation was formed for \$40,000,000 and expected to have an initial paid-in capital of \$40,000,000 that was anything like this?

A. Yes. Every one of the investment trusts formed during that period had identically the same experience.

Q. You mean they didn't have any commitments—

A. Oh, I don't know about that. Ordinarily, when a corporation is what is considered a closely held corporation, we do not have quite the same formality as to written agreement as you would with a public offering.

Q. Yes; but it cannot be said to be closely held when Founders General is allotted 500,000 shares to sell. That is not exactly closely held?

A. It certainly was unusual, Mr. Stern, for one member of a group forming the company to be out selling stock when, as, and if issued—on a when, as, and if issued basis before the organization was completed. That was unusual. I agree with that.

Q. Well, Mr. Burroughs, you cannot say anything in defense of a practice that enables people not to have binding subscriptions until they have seen what prices the stock will sell at in the market?

A. Well, I would agree with that if our purpose had been to sell all of the stock or substantially all of the stock that was being issued, I would agree perfectly with that statement. But in this case most of the people forming the company were not proposing to sell any of the stock.

Q. But there was no such restriction on Founders. Several of the Founders Group immediately sold and took their profit within the month?

A. I still feel bad about it because I did not sell mine, nor did I have a chance to sell mine.

<sup>52</sup> The subscription agreement between General Investment Corporation and its sponsors dated September 16, 1929, recited in part (id., Commission's Exhibit No. X3423 at 3-B): "This will confirm the adoption by your Corporation (hereinafter called 'Utility'), of the oral agreement, made before your incorporation, among the organizers of your Corporation, The Harris Forbes Corporation (hereinafter called 'Harris Forbes'), United Founders Corporation (hereinafter called 'United'), and American Founders Corporation (hereinafter called 'American'), as follows:—"

<sup>53</sup> Id., Commission's Exhibits Nos. X3424 (p. 12) and X3423-I.

<sup>54</sup> Id., Commission's Exhibits Nos. X3934, X3935, and X3977.

<sup>55</sup> Id., Commission's Exhibit No. X3935.

<sup>56</sup> Id., at 25436-9.

Q. But that still does not answer my question. \* \* \* You haven't anything to say in behalf of a practice which would permit the sponsors of a company—

A. No; I think it is a bad practice and I don't think it should have been done, and if I was identified with a corporation being formed today, I would make sure it was not being done.

However, Mr. Burroughs stated that although he was aware of the contemplated market activities of Founders General Corporation, he did not know that Founders General Corporation started the sale of the General Investment Corporation stock prior to the authorization of its issuance<sup>57</sup> and did not know that Founders General Corporation was reselling these shares to dealers for the account of the United Founders Corporation group.<sup>58</sup> In fact, Mr. Burroughs testified that the details of the distribution of the stock were of slight concern to him although he was president of the investment company.<sup>59</sup>

Q. Now, Mr. Burroughs, you knew in any event that Founders General was going to engage in certain market activities right at the very outset, did you not?

A. Yes, I knew just about that much. I did not pay any attention to how they were going to handle it or anything else.

The discount and the profits, of course, depended on the issuance of the stock at \$12.50 per share and resale in a prevailing market of about \$35 per share<sup>60</sup> which was over twice the current average paid-in value of \$14.57 per share.<sup>61</sup> F. S. Burroughs testified that a prevailing market of in excess of twice the asset value of the stock was "a bad situation."<sup>62</sup> Nevertheless, the sponsors felt no obligation to justify on the basis of the Corporation's earnings the price at which the stock was distributed publicly.<sup>63</sup> And although it would have been a comparatively simple matter for General Investment Corporation to have received the proceeds of the public distribution less selling expenses,<sup>64</sup> The Harris Forbes Corporation did not feel that its sponsorship of General Investment Corporation required it to remedy the situation, possibly because high market prices were common to all investment company stocks.<sup>65</sup> In this respect Mr.

<sup>57</sup> Id., at 25428-9.

<sup>58</sup> Id., at 25439.

<sup>59</sup> Id., at 25413. This lack of interest may have been the result of a sales restriction agreement among the members of the Harris Forbes organization, including Mr. Burroughs, by the terms of which the shares allotted to them by The Harris Forbes Corporation could not have been resold for a period of time. (Id., at 25409.)

<sup>60</sup> Id., at 25440.

<sup>61</sup> Id., Commission's Exhibit No. X3424 (p. 12).

<sup>62</sup> Id., at 25431-2.

<sup>63</sup> Id., at 25441.

<sup>64</sup> Id., at 25442N3 (testimony of F. S. Burroughs):

Q. \* \* \* you had stated that it was practically inevitable when stock was brought out by a corporation and investment trust that it would immediately jump way in advance of the asset value?

A. That is correct.

Q. And that was fairly common knowledge?

A. Very common knowledge.

Q. Why was it not a simple matter then to sell the securities to the public through an agent who would get a fixed fee and for all the money that came from the sale of the stock to go into the corporation?

A. \* \* \* I think it would have been.

<sup>65</sup> Id., at 25433.

Granbery testified: <sup>66</sup>

Q. \* \* \* I am asking you whether you, as director of these companies, felt any concern about the fact that \$12.50 was paid for stock into the company, which stock was then sold to the public at \$30, and whether that price structure gave you any concern?

A. No, sir; because an investment trust—if you increase the assets, you increase the value of the investment trust, and at that time you will find the investment trust was selling at two, three, and four times their asset value.

The Harris Forbes Corporation even contemplated an increment in the asset value of the stock held by its individual members to whom it made allotments by virtue of additional issues of General Investment Corporation stock at prevailing market prices which were higher than the allotment prices. Mr. Burroughs testified: <sup>67</sup>

As a matter of fact it was the going rule of thumb at that time that any investment trust could sell at anywhere from three to four times the portfolio value of its assets.

It was a fact that all investment trusts were selling on that basis. It seems kind of foolish now, but that was the situation.

\* \* \* \* \*

Q. \* \* \* Now while you people were restricted [from selling your holdings of General Investment Corporation common stock <sup>68</sup>] for that period of time new money was coming in at \$35 [per share] and increasing your asset value?

A. That is correct and we expected to make it worth a lot more. There isn't any doubt about that.

d. \$4,137,000 Increase in Asset Value of Stock Issued by General Investment Corporation to Sponsors by Reason of Subsequent Issue of Stock to Public at Higher Prices—\$9,978,000 Excess Beyond Paid-in Asset Value Paid by Public Purchasing Stock of General Investment Corporation for \$20,067,000

Apart from the advantages of (a) \$56,250,000 discount in market value received by the sponsors on their subscription to the stock of General Investment Corporation (of which a \$6,234,467.50 profit was realized by them on the almost immediate resale of part of their investment in the investment company), and (b) the opportunity afforded to them to dispose of \$19,645,665.85 securities to the newly formed company at a profit of at least \$4,448,235.71, the sponsors received two additional advantages in connection with the organization of the investment company: (c) an increase in the asset value of their investment in the investment company by reason of the public distribution of additional common stock at prices higher than they paid; and the control of a large investment company (a substantial part of whose funds were contributed by the public) which in turn dominated numerous utility enterprises. This control of the public's funds and of the utility companies was achieved through the investment by these sponsors of only a comparatively slight amount of cash.

<sup>66</sup> Id., at 25308.

<sup>67</sup> Id., at 25429, 25433, and 25444–5. According to Mr. Burroughs, the United Founders Corporation group had even published a bulletin explaining that excess of market price over asset value was axiomatic for investment company stocks. (Ibid.)

<sup>68</sup> See note 59, *supra*.

By September 23, 1929, General Investment Corporation had issued to its sponsors and Founders General Corporation a total of 2,500,000 shares of common stock for \$37,237,830 and 500,000 shares of Class A stock for \$6,250,000 and purchase warrants for \$250,000 or total paid-in capital of \$43,737,830.<sup>69</sup> Since the Class A shares were entitled to equal participation with the common stock in the assets and earnings of the investment company,<sup>70</sup> the asset value of the Class A stock and of the common stock was \$14.57 per share. The public distribution of General Investment Corporation stock by Founders General Corporation which had been effected by September 23, 1929 included the sale of 748,000 shares of common stock for \$20,067.381 (including the 500,000 shares purchased from General Investment Corporation for \$12,237,830 and the sale of a block of 248,000 shares of common stock by the United Founders Corporation group through Founders General Corporation for \$7,079,631, or at a profit to United Founders Corporation group of \$3,979,631.<sup>71</sup> The United Founders Corporation group therefore still held a balance of 250,000 shares of Class A stock and 930,000 shares of common stock, all of which had an asset value of \$14.57 per share or an aggregate asset value of \$17,192,600, but which had cost the United Founders Corporation group \$12.50 per share or an aggregate of \$14,750,000. This aggregate cost was \$2,442,600 less than the current asset value. The Harris Forbes organization held at the time 250,000 shares Class A stock and 650,000 shares of the General Investment Corporation common stock at a cost of \$11,250,000,<sup>72</sup> but the aggregate paid-in value of these shares had been increased to \$12,963,000, or \$1,713,000 over cost.

These increases in paid-in value as previously noted<sup>73</sup> were contemplated by Harris Forbes & Company at the time of organization of General Investment Corporation as the intended result of subsequent public sales of the stock of this investment company at prices higher than the price at which the shares were issued to the sponsors. It is to be noted, however, that conversely the public had paid \$20,067.381 for 748,000 common shares<sup>74</sup> with an asset value of \$14.57 per share or an aggregate asset value of only \$10,089,360, and that the management was little concerned with this discrepancy.<sup>75</sup>

e. Opportunity afforded sponsors to dominate numerous utility enterprises through General Investment Corporation with but relatively small cash outlay for General Investment Corporation

Finally it is to be noted that, as has been indicated, with a comparatively small cash investment the sponsors controlled a large pool of funds which they used to acquire a dominant position in numerous utilities.<sup>76</sup> The United Founders Corporation group in effect not only made no cash contribution to General Investment Corporation but really improved its cash position by its participation in the for-

<sup>69</sup> Id., Commission's Exhibit No. X3424 (p. 12).

<sup>70</sup> See *supra*, pp. 504-5.

<sup>71</sup> *Op. cit.* *supra*, note 1, Commission's Exhibits Nos. X3875, X3424 (p. 12), X3979.

<sup>72</sup> See Table 3, *supra*, p. 506.

<sup>73</sup> See *supra*, pp. 511-15.

<sup>74</sup> *Ibid.*

<sup>75</sup> *Ibid.*

<sup>76</sup> The utility affiliates of the investment company will be discussed hereafter in connection with investment policy; see *infra*, pp. 584-618.



mation of the investment company, because the United Founders Corporation group sold \$13,277,908.20 of its portfolio securities to General Investment Corporation.<sup>77</sup> By this sale, the \$20,000,000 cash contribution of the United Founders Corporation group to the initial capital of the investment company was in effect reduced to \$6,722,091.80; and the subsequent resale to the public by the United Founders Corporation group of 330,064 shares of their common-stock holdings in General Investment Corporation for \$9,406,609.25<sup>78</sup> left the United Founders Corporation group with a \$2,684,517.45 improvement in its cash position besides joint control with The Harris Forbes Corporation of the investment company.

So, too, The Harris Forbes Corporation which had paid \$11,250,000 for its holdings of General Investment Corporation stock,<sup>79</sup> reduced this cash outlay by the simultaneous sale of its portfolio securities to the investment company for \$6,367,757.65<sup>80</sup>. This cash outlay was further reduced to about \$3,000,000 by the resale to the public by The Harris Forbes Corporation of 67,064 shares of its common stock holdings in General Investment Corporation for \$1,792,678.25.<sup>81</sup> Nevertheless, The Harris Forbes Corporation secured the management and joint control with the United Founders Corporation group of an investment company whose contributed capital aggregated \$76,000,000.

## 2. DISTRIBUTION OF GENERAL INVESTMENT CORPORATION COMMON STOCK IN 1930 BY ALBERT E. PIERCE & COMPANY—\$518,000 PROFIT TO UNITED FOUNDERS CORPORATION GROUP

The last block of common stock issued for cash by General Investment Corporation consisted of 134,372 shares issued to Albert E. Pierce & Company for \$2,756,184 during the first half of 1930.<sup>82</sup> On March 19, 1930, General Investment Corporation entered into a contract with Albert E. Pierce & Company by the terms of which the latter agreed to use its best efforts to distribute 800,000 shares of common stock at the following prices:

100,000 shares at \$20-----	\$2, 000, 000
200,000 shares at \$22-----	4, 400, 000
500,000 shares at \$24-----	12, 000, 000
<hr/>	
Total -----	<sup>83</sup> 18, 400, 000

Although apparently the management of General Investment Corporation felt at that time that \$18,000,000 additional capital was desirable, it was in part through the activities of the United Founders Corporation group, one of the sponsors of General Investment Corporation, that the contemplated distribution of all these shares was not achieved. Albert E. Pierce & Company had agreed to "run the

<sup>77</sup> See note 33, *supra*.

<sup>78</sup> See note 50, *supra*.

<sup>79</sup> See Table 3, *supra*, p. 506.

<sup>80</sup> See note 33, *supra*.

<sup>81</sup> See note 50, *supra*.

<sup>82</sup> See Table 3, *supra*. The relationship of General Investment Corporation's investment policy to the Pierce interests will be discussed hereafter.

<sup>83</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. X3423-3E.

market" in the stock for 90 days starting March 15, 1930.<sup>84</sup> In connection with this operation, Albert E. Pierce & Company found it necessary to purchase blocks of this common stock, the principal blocks being purchased from Benton & Co.,<sup>85</sup> a nominee of the United Founders Corporation group.<sup>86</sup> Albert E. Pierce was apparently ignorant of this relationship between Benton & Co., and the United Founders Corporation group.<sup>87</sup> During March and April 1930, while Albert E. Pierce & Company was making purchases in an attempt to maintain the market and distribute stock, the United Founders Corporation group sold a total of 100,000 shares of the stock for \$1,798,562.56 at a profit of \$518,911.15,<sup>88</sup> and of these shares over 23,000 were sold to Albert E. Pierce & Company.<sup>89</sup>

### 3. RECLASSIFICATION OF STOCK—STOCK OUTSTANDING WHEN CONTROL OF GENERAL INVESTMENT CORPORATION WAS ACQUIRED BY ERNEST B. WARRINER IN 1936

As heretofore summarized, \$27,161,155.43 of the contributed capital to General Investment Corporation was in the form of portfolio securities.<sup>90</sup> With the exception of the issuance by General Investment Corporation of its preferred stock in the amount of \$14,606,506.50 in exchange for United States and Overseas Corporation and the issuance by General Investment Corporation of its common stock in the amount of \$5,374,990 for securities<sup>91</sup> of the Associated Gas and Electric Company system, other securities issued by General Investment Corporation in exchange for securities of other companies were relatively small, although control of Indiana Consumers Gas and By-Products Company<sup>92</sup> and joint control of Cuba Company were acquired through exchanges.<sup>93</sup>

In July 1933 the stockholders of General Investment Corporation voted to consolidate the outstanding shares of capital stock of the company by reclassifying the 500,000 Class A shares into 100,000

<sup>84</sup> Id., Commission's Exhibit No. X4103.

<sup>85</sup> Id., Commission's Exhibit No. X4104.

<sup>86</sup> Id., Commission's Exhibits Nos. X3636, X3638, X3708.

<sup>87</sup> On August 25, 1930, Albert E. Pierce & Company, which was still distributing common stock of General Investment Corporation (id., Commission's Exhibit No. X4106), wrote to Harris, Forbes & Company (id., Commission's Exhibit No. X4104): "I am enclosing herewith report on some of the accounts which for one reason or another look to us as if it might be concentrated stock which possibly should not come into the market. I would be glad to have your organization make a check of at least some of the stock purchases for each of these accounts and see if it is coming from sources who pledge themselves to hold the stock."

Included in the accounts listed were Benton & Company, in whose name the following amounts of shares were sold to Albert E. Pierce & Company (ibid.):

	<i>Shares</i>
March-----	5,940
April-----	17,925
May-----	1,700
June-----	100
July-----	200

<sup>88</sup> Id., Commission's Exhibit No. X3878.

<sup>89</sup> See note 87, *supra*.

<sup>90</sup> See Table 3, and *supra*, pp. 505-10.

<sup>91</sup> See Table 3, *supra*.

<sup>92</sup> Op. cit. *supra*, note 1, Commission's Exhibits Nos. X3984, X3985, and X3424 (pp. 32-34).

<sup>93</sup> Id., Commission's Exhibits Nos. X3993, X3970, and X3424 (pp. 32-34).

Class A shares, by reclassifying each two shares of the outstanding preferred stock into one new share of preferred stock having a liquidating preference of \$115 per share, and each 5 shares of the outstanding common stock into one new share of common stock.<sup>94</sup> Thereafter, as will be discussed in detail, the corporation in 1934 and 1935 made several offers of exchange of its common stock and of a new \$3 prior preferred stock for its outstanding preferred stock, and, in addition, repurchased substantial amounts of its outstanding preferred stocks at discounts below asset value.<sup>95</sup>

On August 3, 1936, control of the General Investment Corporation was transferred to International Equities Corporation, an investment company controlled by one Ernest B. Warriner.<sup>96</sup> As at that date, General Investment Corporation had outstanding 1,279 shares of \$3 prior preferred stock, 63,050 shares of cumulative preferred \$6 Dividend Series Shares, 1,136,756 common shares stock, and 100,000 shares of Class A stock.<sup>97</sup>

#### 4. ISSUE OF PREFERRED STOCK BY GENERAL INVESTMENT CORPORATION IN ACQUISITION OF UNITED STATES & OVERSEAS CORPORATION

##### a. Organization of United States & Overseas Corporation

As has been indicated,<sup>98</sup> starting in September 1930, General Investment Corporation issued 254,026 shares of preferred stock for an aggregate of \$14,606,506.50 in connection with its acquisition at a cost of \$21,679,711.27 of United States & Overseas Corporation.<sup>99</sup> Substantially the entire balance of \$6,993,204.57 of the cost price of United States & Overseas Corporation was paid by General Investment Corporation by the reissue of 390,967 shares of common stock held in treasury at a valuation of \$5,675,629.53, and the reissue of 18,805 shares of cumulative preferred \$3 dividend series, held in the treasury, at a valuation of \$953,037.50.<sup>100</sup>

On January 23, 1929, United States & Overseas Corporation had been organized<sup>101</sup> as an intermediate credit company<sup>102</sup> by Harris, Forbes & Company, N. W. Harris & Co., Deutsche Bank und Discountgesellschaft (hereinafter called the Deutsche Bank)<sup>103</sup> and

<sup>94</sup> Id., Commission's Exhibit No. X3423-1-2.

<sup>95</sup> Id., Commission's Exhibits Nos. X3424 (pp. 21 et seq.) and X4129.

<sup>96</sup> For detailed discussion of this acquisition of control by Ernest B. Warriner and the consequences thereof see *infra*, pp. 584-618. For detailed discussion of the association of Ernest B. Warriner with Wallace Groves' acquisition of other investment companies see also Investment Companies Acquired and Controlled by Wallace Groves, *supra*, pp. 181-226.

<sup>97</sup> *Op cit. supra*, note 1, Commission's Exhibit No. X3424 (p. 15). In addition to the repurchases of its own outstanding preferred shares of General Investment Corporation prior to the time of acquisition of control by Ernest B. Warriner, as will be discussed hereinafter, the investment company during the period that Warriner controlled it spent approximately \$3,000,000 to repurchase additional shares of its preferred and common stock, primarily from Wallace Groves. (Commission's Exhibit No. X3424 at 23, 25, and 26.) The greater part of these shares was still held in treasury unretired at the middle of 1938.

<sup>98</sup> See *supra*, pp. 505-10.

<sup>99</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. X4111.

<sup>100</sup> Id., Commission's Exhibit No. X3424 (pp. 12, 13, 20, and 24).

<sup>101</sup> Id., Commission's Exhibit No. X3959.

<sup>102</sup> Id., at 25356.

<sup>103</sup> Id., at 25366. The Deutsche Bank was the largest and most important bank in Germany.

American Founders Corporation.<sup>104</sup> United States & Overseas Corporation was conveyed by Harris, Forbes & Company,<sup>105</sup> and was created for the purpose of lending nonmarketable intermediate credits, principally in Germany. E. Carleton Granbery, the president of United States & Overseas Corporation,<sup>106</sup> testified:<sup>107</sup>

Q. What was the purpose for which the United States & Overseas was formed?

A. The primary purpose was to make loans of a nonmarketable character, which I would term intermediate credits, and while there was no understanding, practically all of these loans or possible loans were made in Germany. In addition to the primary purpose, we expected to buy other investments of whatever nature we wanted, securities.

Q. And these intermediate credits were either long-term or short-term?

A. Yes. They might be five years, ten years, or anything of that nature. It was not like a bank loan, and it was nonmarketable. It was usually issued in just one or two pieces.

By September 1930 United States & Overseas Corporation had issued 750,000 shares of its common stock for \$19,200,000<sup>108</sup> and had issued 300,000 shares of its Class A common stock for \$3,000,000.<sup>109</sup> The common stock was entitled to priority in liquidation to an aggregate of \$19,200,000, an amount equal to the proceeds of distribution of this stock, but enjoyed no priority in dividends or undivided profits in liquidation.<sup>110</sup> The Class A stock enjoyed 33⅓% of the combined voting power of both classes of stock (common and Class A) and was junior to the common only in liquidation.<sup>111</sup>

Initially, in January 1929, United States & Overseas Corporation raised \$2,000,000 of capital by the issuance of 200,000 shares of stock at \$10 per share. Of this block, American Founders Corporation purchased 50,000 shares of \$500,000, and Deutsche Bank, Harris Forbes & Company, and N. W. Harris & Co. purchased the remaining 150,000 shares for \$1,500,000.<sup>112</sup> Between April and June 1929 United States & Overseas Corporation raised \$4,000,000 additional capital by the issuance of 400,000 shares of stock at \$10 per share.<sup>113</sup> Of this block, American Founders Corporation on April 22, 1929, purchased 50,000 shares for \$500,000.<sup>114</sup>

Between April and June 1929, the sponsorship of the United States & Overseas Corporation was enlarged in accordance with the plans formulated at the time of its creation<sup>115</sup> to include the First National Corporation of Boston, Guardian Detroit Co., Inc., Central Hanover

<sup>104</sup> Id., at 25355 and Commission's Exhibit No. X3960.

<sup>105</sup> Id., Commission's Exhibit No. X4248 (p. 47).

<sup>106</sup> Id., Commission's Exhibit No. X4248 (pp. 47-49). Mr. Granbery of Harris Forbes & Company negotiated the formation of United States & Overseas Corporation and served as its president. (Id., at 25355 et seq.)

<sup>107</sup> Id., at 25356.

<sup>108</sup> Id., Commission's Exhibit No. X3960.

<sup>109</sup> Ibid.

<sup>110</sup> Id., Commission's Exhibit No. X3959.

<sup>111</sup> Ibid.

<sup>112</sup> Id., Commission's Exhibit No. X3960.

<sup>113</sup> Ibid.

<sup>114</sup> Id., Commission's Exhibit No. X3961. In June 1929, American Founders Corporation financed its co-sponsors in their participation in this expansion by purchasing from Deutsche Bank and Harris, Forbes & Company an additional 50,000 shares at \$10 per share, giving to the sellers the option of repurchasing the shares before January 2, 1930, at \$10.50 per share, plus 6% interest. (Ibid.)

<sup>115</sup> Id., at 25357.

Bank and Trust Company, Bancamerica-Blair Corporation, Credit Suisse, Banque Commerciale de Bale and Skandinaviska Kreditaktiebolaget of Stockholm.<sup>116</sup>

In September 1929, at the same time that General Investment Corporation was organized and its stocks distributed to the public, The Harris Forbes Corporation headed a syndicate which publicly distributed the stock of United States & Overseas Corporation. This syndicate, composed of The Harris Forbes Corporation, American Founders Corporation, Bancamerica-Blair Corporation, First National Corporation of Boston, Guardian Detroit Co., and N. W. Harris and Co.,<sup>117</sup> purchased from United States & Overseas Corporation 450,000 shares of its common stock at \$36 per share for a total of \$16,200,000, thereby increasing the contributed capital to United States & Overseas Corporation to \$22,200,000.<sup>118</sup> The syndicate also purchased from the sponsors of the corporation, who then held 300,000 common shares at a cost of \$10 per share,<sup>119</sup> a total of 150,000 shares at \$20 per share for a total of \$3,000,000, which gave a profit of \$1,500,000 to the sponsors. The syndicate in turn sold the two blocks of common stock, an aggregate of 600,000 shares, costing the syndicate \$19,200,000, to the public at \$35 per share for a total of \$21,000,000, which gave the syndicate a distribution spread of \$3 per share, or an aggregate spread of \$1,800,000.<sup>120</sup>

It is significant that the results of the public distribution of United States & Overseas Corporation common stock were identical with that of General Investment Corporation. The public distribution increased the paid-in common stock capital of United States & Overseas Corporation to \$25.60 per share while for the Class A stock the contributed capital remained at \$10 per share.<sup>121</sup> As a result, the 150,000 shares of common stock and the 300,000 shares of Class A stock of United States & Overseas Corporation which the sponsors retained at an aggregate cost of \$4,500,000 increased in asset value to \$5,840,000. This increase in asset value was exclusive of the profit of \$1,500,000 realized on resale to the public by the sponsors of part of their common stock. This increase in asset value of the stock held by the sponsors was gained at the expense of the public which purchased 600,000 shares of common, which had a paid-in equity of \$25.60 per share, or a total paid-in equity of \$15,360,000, at a price of \$35 per share, or a total cost to the public of \$21,000,000.<sup>122</sup> The sponsors who underwrote the stock of United States & Overseas Corporation knew at the inception of the public distribution the amount by which the asset value of the shares which they retained would be increased, for they contemplated offering the stock to the public at \$35 per share,<sup>123</sup> while in the case of the General Investment Corporation common stock the precise increase in asset value of the stock retained by the sponsors could not be contemplated since the offering to the public was made at market price by Founders General Cor-

<sup>116</sup> Id., Commission's Exhibit Nos. X3963, X3964, X3424 (p. 71).

<sup>117</sup> Id., Commission's Exhibit No. X3964.

<sup>118</sup> Id., Commission's Exhibit No. X3960.

<sup>119</sup> Id., at 25359.

<sup>120</sup> Ibid.

<sup>121</sup> Id., Commission's Exhibit No. X3963 (p. 4).

<sup>122</sup> Id., at 25361.

<sup>123</sup> Id., at 25359-60.

poration as agent for the General Investment Corporation.<sup>124</sup> According to Mr. Granbery, president of the United States & Overseas Corporation, the price of \$35 per share at which the stock was distributed was accompanied by a high rate of earnings on the contributed capital from June to September 1929, although the sponsors did not know whether or not such a rate of earnings could be maintained.<sup>125</sup>

As was the case in General Investment Corporation, United States & Overseas Corporation was used as the vehicle whereby the burden of special situations that had developed in the investment banking business of Harris, Forbes & Company and the other sponsors could be shifted to the public. By September 1929, of the \$6,000,000 capital contributed to United States & Overseas Corporation by the syndicate members, \$3,171,877.50 was expended in the purchase of securities from sponsors—\$1,213,000 had been invested by United States & Overseas Corporation in domestic securities acquired from the Harris Forbes organizations, \$62,500 in securities bought from United Founders Corporation, and \$1,896,377.50 in participations in German credits with Deutsche Bank.<sup>126</sup> The resale to the public by the sponsors of part of the shares of United States & Overseas Corporation which they had originally acquired and the contribution to the company of additional cash by the public reduced the extent of the interest of the sponsors in these special situations. In lieu of wholly owning these investments which were sold to United States and Overseas Corporation, the sponsors had an indirect and reduced interest in these investments and had additional cash and an interest in the cash of United States & Overseas Corporation.

#### b. The Acquisition by General Investment Corporation of United States & Overseas Corporation—Advantages to Sponsor

By November of 1930, United States & Overseas Corporation had invested approximately \$14,000,000 in "intermediate credits" to German companies.<sup>127</sup> By the autumn of 1930, the investment quality of German "intermediate credits" was at least questionable. F. S. Burroughs, president of General Investment Corporation, testified that it was possible that General Investment Corporation "would not have looked for more German credits at that time."<sup>128</sup>

<sup>124</sup> See *supra*, pp. 510-11.

<sup>125</sup> *Id.*, at 25362 and 25364. However, for the initial fiscal period ending November 30, 1929, United States & Overseas Corporation earned only 6% on its average paid-in capital. (*Id.*, Commission's Exhibit No. X3956.) Apparently Mr. Granbery was referring either to capital gains later offset by capital losses after the break in the market in October 1929 or else to paper profits—unrealized appreciation in the market value of assets—which evaporated in the break of the stock market before the end of the fiscal period.

<sup>126</sup> *Id.*, Commission's Exhibit No. X3962.

<sup>127</sup> *Id.*, Commission's Exhibit No. X3966 A-2. The two principal credits included are discussed *infra*.

<sup>128</sup> *Id.*, at 25469-70. James Warburg, a director of American and Continental Corporation, another of the United Founders Corporation group of companies which had extensively lent its funds to German industry, stated before this Commission that the competition among various banking houses making German loans had caused a decline in the attractiveness of such investments and in fact that by the autumn of 1930 German credits had saturated the American market. Moreover, he stated that growing political unrest in Germany was a factor then affecting the value of German loans. Mr. Warburg stated: " \* \* \* the competition increased in inverse ratio to the desirability of the business". (*Id.*, Commission's Exhibit No. X4246 (pp. 28, 30, and 31).)

However, Harris Forbes & Company, in September of 1930, were of the opinion that the German credits held by United States & Overseas Corporation were sound investments.<sup>129</sup> Harris Forbes & Company therefore adopted the suggestion of the Deutsche Bank,<sup>130</sup> one of the sponsors of United States & Overseas Corporation, that that corporation be combined with General Investment Corporation on the ground that it would be "less companies."<sup>131</sup> To accomplish this combination, General Investment Corporation, on September 8, 1930, offered to exchange (a) a package consisting of 3 shares of its preferred stock, 5 shares of its common stock, and warrants to purchase 7 shares of its common stock for each 10 shares of United States & Overseas Corporation common stock and (b) a package consisting of 5 shares of its preferred stock and warrants to purchase 24 shares of its common stock for each 24 shares of United States & Overseas Corporation's Class A stock.<sup>132</sup> Eventually General Investment Corporation acquired all the Class A stock and 97% of the common stock of United States & Overseas Corporation, as a result of this offer, plus some small cash purchases.<sup>133</sup>

The ratios and classes of securities to be exchanged were determined by representatives of The Harris Forbes Corporation and of the United Founders Corporation group<sup>134</sup> at a time when these organizations controlled General Investment Corporation and were the principal sponsors of United States & Overseas Corporation. Both The Harris Forbes Corporation and the United Founders Corporation group had a substantial pecuniary interest in the terms of the exchange because of their ownership of blocks of the Class A stock and common stock of United States & Overseas Corporation and their ownership of blocks of Class A stock and common stock of General Investment Corporation. On September 8, 1930, the United Founders Corporation group owned 75,000 shares of the Class A and 173,221 shares of the common stock of United States & Overseas Corporation and 250,000 shares of the Class A and 743,586 shares of the common stock of General Investment Corporation;<sup>135</sup> The Harris Forbes Corporation held 36,667 shares of the Class A and 53,125 shares of the common stock of United States & Overseas Corporation and 250,000 shares of Class A and an unknown amount of common stock of General Investment Corporation.<sup>136</sup>

The terms of the exchange offers were favorable to the holders of the securities of United States & Overseas Corporation, particularly to the holders of the Class A stock of United States & Overseas Corporation.

<sup>129</sup> *Id.*, at 25357.

<sup>130</sup> *Id.*, at 25467.

<sup>131</sup> *Ibid.*

<sup>132</sup> *Id.*, at 25464.

<sup>133</sup> *Id.*, Commission's Exhibits Nos. X3966-A and X4111.

<sup>134</sup> The terms of the exchange were negotiated by E. Carlton Granbery of Harris Forbes & Company acting on behalf of United States & Overseas Corporation and Frederick Burroughs of Harris Forbes & Company, and George Devendorf of the United Founders Corporation group acting on behalf of General Investment Corporation. (*Id.*, at 25468.)

<sup>135</sup> *Id.*, Commission's Exhibits Nos. X3927 and X3424 (p. 27).

<sup>136</sup> *Id.*, Commission's Exhibit No. X3424 (p. 71). As previously indicated (see note 59 *supra*), The Harris Forbes Corporation allotted the common stock of General Investment Corporation to its own stockholders. Their disposition of the stock is for the greater part unknown to the Commission although Mr. Burroughs testified that the stock was allotted subject to a sales restriction agreement.



The exchange for the common stock of United States & Overseas Corporation was made on an equal asset value basis.<sup>137</sup> However, the value in liquidation of the preferred stock which was exchanged by General Investment Corporation for the Class A stock of United States & Overseas Corporation was substantially in excess of the liquidating value of the Class A stock received. The 62,500 shares of its cumulative preferred \$3 dividend shares with a liquidating preference in assets of \$3,593,750 issued by General Investment Corporation<sup>138</sup> exceeded the then liquidating value of the 300,000 shares of Class A common stock of United States & Overseas Corporation received in exchange for this General Investment Corporation preferred stock. Although The Harris Forbes Corporation and the United Founders Corporation had a substantial investment in the stock of General Investment Corporation, this exchange resulted in burdening the public holders of the common stock of General Investment Corporation with an excessive cost for the Class A stock of United States & Overseas Corporation purchased from the management of General Investment Corporation and from others associated with them in the sponsorship of the United States & Overseas Corporation. Mr. Burroughs testified:<sup>139</sup>

Q. The figures that we have here, Mr. Burroughs, indicate, and we will let you figure them out for yourself if there is any question about it, that the common shares of U. S. & Overseas had a liquidating value of \$25.60, and that left a stated value of about \$9.79 per share of Class A.

A. What date was that?

Q. This was November 30th, 1930.

A. That \$25.60 figure that you have is familiar to me. I seem to remember that.

Q. That is the preference in value over Class A.

Q. Now, if the stated value and surplus and undivided profits of U. S. & Overseas were \$22,000,000, and there were 750,000 shares of common, that would have left a value of \$9.79 per share of Class A on liquidation. Now, if a block of 24 shares of Class A would accordingly have \$234.96, that is 24 times \$9.79 for this block, the Class A shareholders received five shares of P. U. H. [Public Utility Holding Corporation, subsequently known as General Investment Corporation] preferred, which was entitled on liquidation to \$57.50, which was a total of \$287.

A. The par was \$50. It was only entitled to \$57.50 at most on liquidation, but we only figured the par value, because that is the basis.

Q. Yes, I realize that there might have been some reason. I was just pointing out there was a difference in liquidating value of about \$50 on the 24 shares of Class A over what they had had in U. S. & Overseas.

A. Well, we had to make some inducement over their bare asset value.

Q. So your idea was, as far as this offer of exchange to U. S. & Overseas, was an offer that P. U. H. wanted very much to go through, that inducement had to be made to U. S. & Overseas stockholders?

<sup>137</sup> Id., at 25465-6. For the purpose of the exchange, the intermediate German loans, which constituted about two-thirds of the assets of United States & Overseas Corporation, were valued at their cost. As at November 30, 1930, net assets of United States & Overseas Corporation totaled \$20,965,531, of which approximately \$14,000,000 represented the cost of loans made to German and other foreign companies. (Id., Commission's Exhibit No. X3966.)

<sup>138</sup> Id., Commission's Exhibit No. X3423-5b (p. 10).

<sup>139</sup> Id., at 25470-2.



A. Yes, P. U. H. was anxious to do it because it increased our assets, increased the resources of the company, made it larger and we were at that time anxious to have more capital.

Q. Mr. Burroughs, my attention is called to the fact that at a subsequent time the P. U. H. Corporation wrote down its portfolio \$2,548,502.90 [\$2,886,-221.16]<sup>140</sup> to adjust the U. S. & Overseas holdings to their asset value. Do you recall anything about that?

A. That was quite a bit later, wasn't it?

Q. It was quite a bit later?

A. Yes.

Q. But it does show there was an excess over asset value, the price at which it was taken over?

A. I think quite probably there was an excess even at the time of the exchange \* \* \*.

Any dilution in the asset value of the sponsors' holdings of General Investment Corporation common stock as a result of the exchange was to some extent at least compensated by the fact that they received 87,976 shares of the preferred stock of General Investment Corporation having a total preferred liquidating value of \$5,058,620,<sup>141</sup> which they obtained in exchange for their United States & Overseas Corporation common and Class A common stock.<sup>142</sup>

United States & Overseas Corporation was subsequently liquidated<sup>143</sup> by the surrender of its capital shares held by General Investment Corporation in exchange for its assets valued at cost.<sup>144</sup> General Investment Corporation recorded a loss of \$2,886,221.16 on its holdings in United States & Overseas Corporation shares by the time United States & Overseas Corporation was liquidated in May 1934.<sup>145</sup>

In addition, losses of \$6,385,386.50 were eventually sustained by General Investment Corporation on German credits which it acquired from the United States & Overseas Corporation.<sup>146</sup>

<sup>140</sup> Id., Commission's Exhibit No. X4111.

<sup>141</sup> Id., Commission's Exhibit No. X3424 (p. 71).

<sup>142</sup> Ibid. The Class A stockholders of United States & Overseas Corporation received a completely preferred position in General Investment Corporation and the common stockholders of United States & Overseas Corporation, including the United Founders Corporation group and Harris Forbes & Company, received in return for their stock a preponderantly preferred position in General Investment Corporation. For each 10 shares of their common stock having a total asset value of \$265 (id., Commission's Exhibit No. X3966 at p. 3) General Investment Corporation issued in addition to common stock 3 shares of its preferred stock having a liquidating preference of \$172.50. Mr. Burroughs testified (id., at 25473) :

Q. Then what happened actually was that these persons who held a junior interest in U. S. & Overseas, were given a senior interest in Public Utility Holding Corporation, and at the price in excess of the asset value that they turned in?

A. To both classes of U. S. & Overseas we gave them senior securities of P. U. H. [Public Utility Holding Corporation, subsequently known as General Investment Corporation]. We considered it just as though we were buying the portfolio from them, just as though we were buying the portfolio from U. S. & Overseas.

Q. That was the reason for giving them this senior stock?

A. That is correct; yes.

Q. However, that technique does not admit of this situation at a time when possibly matters cannot be settled in case that a person is given a junior interest in one corporation, if he is an insider, will be given a senior interest in another corporation by an allied group and thereby taken from an unpreferred into a preferred position?

A. Well he might have received cash, which would be definitely senior.

<sup>143</sup> Id., Commission's Exhibit No. X4111.

<sup>144</sup> Ibid.

<sup>145</sup> Ibid.

<sup>146</sup> Id., Commission's Exhibits Nos. X3970 and X3424 (p. 61 et seq.).

## D. Investors' and Sponsors' Experience in General Investment Corporation

As heretofore indicated,<sup>147</sup> General Investment Corporation received \$76,334,431.45 proceeds from issues of its securities, consisting of a total of 254,026 shares of preferred stock issued for \$14,606,506.50, a total of 3,143,744 shares of common stock issued for \$55,227,924.95, and a total of 500,000 shares of Class A stock, issued for \$6,250,000 and a total of 50,000 free warrants issued for \$250,000. In connection with the organization of General Investment Corporation, the sponsors had invested a net of \$15,052,476.79, as a result of which they held 500,000 shares of Class A stock and 1,602,872 shares of common stock.<sup>148</sup> In the organization of United States & Overseas Corporation, the sponsors of General Investment Corporation, together with their associates, invested a net of \$1,200,000 and the distributing expenses for which they held 300,000 shares of Class A stock and 150,000 shares of common stock.<sup>149</sup> These shares of United States & Overseas Corporation, by the terms of the exchange offer of 1930, were convertible into 75,000 shares of General Investment Corporation common stock and 107,500 shares of General Investment Corporation preferred stock, enjoying a preference of \$57.50 per share or \$6,181,250.<sup>150</sup> Thus the sponsors of both companies eventually held, by virtue of their participation in the organization of the two investment companies, 1,677,872 shares of General Investment Corporation common stock, 500,000 shares of the Class A stock, and 107,500 shares of its preferred stock (entitled on liquidation to \$6,181,250) at a net cost of \$16,252,476.79.<sup>151</sup> The public for its investment of \$58,438,275.39 received the remaining 1,465,872 shares of General Investment Corporation common stock and 146,526 shares of pre-

<sup>147</sup> See *supra*, pp. 501-4 and 504-16.

<sup>148</sup> *Ibid*.

<sup>149</sup> See *supra*, pp. 518-21. Of the \$22,200,000 contributed to United States & Overseas Corporation by its sponsors as subscribers and underwriters of 750,000 shares of common stock and 300,000 shares of Class A stock, \$21,000,000 was recovered from the public by resale to the public of 600,000 shares of common stock, leaving a net investment of \$1,200,000 and expenses of distribution.

<sup>150</sup> *Ibid*. General Investment Corporation offered 5 shares of common stock and 3 shares of preferred stock for each 10 shares United States & Overseas Corporation common stock, and 5 shares of preferred stock for each 24 shares of United States & Overseas Corporation Class A stock.

<sup>151</sup> These holdings were exclusive of any purchases or sales not incidental to the organization of the companies. The sponsors, in fact, acquired substantial blocks of United States & Overseas Corporation common stock prior to the exchange. (See *op. cit. supra*, note 1, Commission's Exhibit No. X3424, p. 71.) The cost of such acquisitions is not known. Nor are the activities of any of the sponsors other than the United Founders Corporation group in the United States & Overseas Corporation stock or General Investment Corporation stock known. The United Founders Corporation group of publicly owned investment companies eventually recorded net losses of \$9,733,054.42 on its investment in General Investment Corporation (*id.*, Commission's Exhibit No. X3424, p. 30) before allowing for the \$1,301,105.38 profit realized on United States & Overseas Corporation stock (*id.*, Commission's Exhibit No. X3732) and before allowing for the \$1,448,235.71 profit on sale of securities to General Investment Corporation. Thus the United Founders Corporation group sustained a combined net loss of \$6,983,713.33 in General Investment Corporation and United States & Overseas Corporation.

ferred stock (having a preference of \$57.50 per share, or \$8,425,-245.00) of General Investment Corporation.<sup>152</sup>

It is to be noted that after allowing for the preferred stock at its issue price the public held 1,465,872 common shares, or about 40% of the total number of common shares and Class A shares at a cost of \$50,013,030.39, and the sponsors of General Investment Corporation and United States & Overseas, after deducting their preferred stock at its issue price, held about 60% of the combined common shares and Class A shares at a cost of about \$10,071,226.79. Moreover, this \$10,071,226.79 investment by the sponsors was an interest of 60% in the \$61,477,924.95 capital contributed for the common stock and Class A stock so that until such time as General Investment Corporation had suffered losses of over \$44,000,000, the asset value of the sponsors' investment still exceeded their cost.<sup>153</sup> Conversely, the public alone suffered the entire first \$44,000,000 loss in operation by General Investment Corporation.

In all, during the period from 1929 to the middle of 1936, General Investment Corporation lost through operations about \$70,604,248.43. Of the \$78,634,407.57 paid into the investment company,<sup>154</sup> \$2,611,-832.02 was returned to stockholders in the form of repurchase of out-

<sup>152</sup> The above shares represent the balance of the shares issued by General Investment Corporation. The \$58,438,275.39 amount known as the public's investment in General Investment Corporation and United States & Overseas Corporation is arrived at as follows:

Proceeds received by sponsors for 397,128 shares General Investment Corporation common resold at a profit to the public (see Table 3)	\$11,199,287.50
Proceeds received by Founders General Corporation for 600,000 shares of General Investment Corporation common sold to the public (see Table 3)	15,462,850.00
Proceeds received by Albert E. Pierce & Co. for 134,372 shares of General Investment Corporation common sold to the public (see Table 3)	2,756,184.00
Value placed upon general portfolio securities turned in to General Investment Corporation in exchange for 409,082 of its common shares by public (see Table 3)	12,549,892.43
Amount paid by public to underwriters for United States & Overseas Corporation common shares distributed publicly by sponsors (see supra, pp. 518-21)	21,000,000.00
Total	62,968,193.93
Add: Excess of resale price over cost of 390,967 common and 18,805 preferred shares of General Investment Corporation treasury stock exchanged for shares of United States & Overseas Corporation (see supra, pp. 501-4 and 505-10)	1,979,079.80
Total	63,087,762.62
Less: Amount paid by General Investment Corporation for holders of 390,967 of its common and 18,805 of its preferred shares repurchased and then reissued in exchange for United States & Overseas Corporation common shares (op. cit., supra, note 1, Commission's Exhibit No. X3424, pp. 20-24)	4,649,487.23
	58,438,275.39

This cost to the public does not take into consideration any additional investments made by reason of sales of the sponsors of their stock other than at the organization of the two investment companies. Nor does this cost allow for decreases in the public's investment by reason of sales made by the public to the sponsors. (See note 151, supra.)

<sup>153</sup> Losses of \$44,000,000 would reduce the interest of all the common stock and Class A stockholders to about \$17,477,000 and the sponsor's 60% interest therein to about \$10,486,000.

<sup>154</sup> In addition to the \$76,334,431.45 paid into the company for the issue of its securities, \$2,299,976.12 more was contributed to the investment company on the resale of treasury stock at an excess over cost of acquisition and as discount on the retirement of notes. (See supra, pp. 504-5.)

standing securities or in the form of dividends,<sup>155</sup> leaving a net contribution to the investment company after retirements aggregating \$76,022,575.55. Of this General Investment Corporation at the middle of 1936 still had as net assets but \$5,418,327.12,<sup>156</sup> indicating a total loss of \$70,604,248.43 in operation during the period that control of the company vested with the original sponsors.<sup>157</sup> Since the Class A and common stocks had no asset value as at the middle of 1936,<sup>158</sup> the sponsors lost their \$10,071,226.79 Class A and common stock investment in the investment company.<sup>159</sup> However, the public, which had only a 40% interest in the common and Class A stocks, lost its \$50,013,030.39 investment therein,<sup>160</sup> and as hereinafter discussed, the public sustained a substantial loss on its \$8,425,245 investment in the preferred stock as well.

### E. Investment Policies of General Investment Corporation and United States & Overseas Corporation—Conflicts of Interests in Transactions With Sponsors

Although United States & Overseas Corporation and General Investment Corporation participated in common ventures, United States & Overseas Corporation had been organized, as has been previously indicated,<sup>161</sup> for the purpose of supplying intermediate term credits to German enterprises under supervision of the Deutsche Bank. Without exception, the Deutsche Bank had had previous business relationships as a bank creditor with these German enterprises.<sup>162</sup> This arrangement for extending intermediate credits under the sponsorship of a German bank to German enterprises which the bank served as the commercial banker was attended by a possible conflict of interest between the American participants in intermediate credits (General Investment Corporation and United States & Overseas Corporation) and German commercial banks such as the Deutsche Bank which were

<sup>155</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. X3424, p. 10 et seq. This return of capital to the shareholders of General Investment Corporation was not the sole reduction of the combined public investment. In addition, General Investment Corporation paid other than by the issue of its own securities, a total of \$160,713.18 to the shareholders of United States & Overseas Corporation in acquiring 6,580 common shares of that company. (*Id.*, Commission's Exhibit No. X4111.) United States & Overseas Corporation itself distributed to the public owning 26,050 shares of its common stock, being the balance of the 750,000 common shares outstanding not held by General Investment Corporation (*ibid.*), a total of \$606,880 or \$25.60 per share. (*Id.*, Commission's Exhibit No. X3424 [pp. 67X9].)

<sup>156</sup> *Id.*, Commission's Exhibit No. X3423-F. These assets were valued for balance-sheet purposes at cost and at an appraisal in absence of market. (*Ibid.*)

<sup>157</sup> Control was sold to International Equities Corporation in August 1936. (*Op. cit. supra*, note 12, Commission's Exhibit No. 1565.)

<sup>158</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. X3423-F.

<sup>159</sup> The \$10,071,000 cost figure is derived by subtracting the total amount of the preference of the General Investment Corporation preferred stock received by the sponsors from the net cost to them of their entire investment in General Investment Corporation acquired incidental to the organization of General Investment Corporation and United States & Overseas Corporation and the exchange of the stock of General Investment Corporation for that of United States & Overseas Corporation.

<sup>160</sup> This investment cost is computed similarly to that of the sponsors. (See note 152, *supra*.)

<sup>161</sup> See *supra*, pp. 518-21.

<sup>162</sup> *Id.*, at 25356 and 25366.

also lending short-term credits to the borrowers.<sup>163</sup> Inasmuch as the sponsors' investment in the companies was subject to relatively slight risks of immediate loss, this relationship prejudiced their investment position but slightly. However, against the possible risk, the investment companies and the public investing in their stocks were without protection. Mr. Granbery, president of the United States & Overseas Corporation, when examined with respect to the existence of any protection to the investment companies, testified: <sup>164</sup>

Q. Had you any protection against the Deutsche Bank placing in the United States & Overseas investments and credits that it might find desirable not to continue holding?

A. I don't think such an occasion ever arose. The only protection we had was that we passed—the American directors had the final say as to whether we would make a credit or not, and we relied upon our German experts to a large extent concerning the credit and standing of the company. The Deutsche Bank was not the type of a bank in my mind against whom you had to protect yourself. They were our partner.

To the extent that such conflict of interest in fact existed, the risk of the investment companies was substantial. For example losses of over \$6,385,000 were sustained by General Investment Corporation on German credits extended by United States & Overseas Corporation to the clients of Deutsche Bank, one of the sponsors of United States & Overseas Corporation.<sup>165</sup>

The combined operations of General Investment Corporation and United States & Overseas Corporation extended from financing electric-utility construction in Germany to financing construction of a subway in the Argentine. The investment activities of these two investment companies may be placed into three categories: extension of credits to German enterprises; acquisition of control of foreign and domestic utilities; and investments in support of the investment-banking activities of Harris, Forbes & Company and other investment bankers for the enterprises which Harris Forbes & Company served as banker. To some extent, the first and second categories of these activities each overlapped with the third category. In line with the policy of Harris Forbes & Company "to get an important position in as many utility groups as possible,"<sup>166</sup> a substantial portion of the capital contributed to General Investment Corporation was invested from time to time to obtain a dominant interest in public-utility corporations having total resources in excess of \$811,600,000.

As indicated in Table 4, the losses resulting were to a substantial extent realized from investments in utility systems for which Albert E. Pierce & Company, was the sponsor or the principal distributor. Albert E. Pierce's relationship to General Investment Corporation is noteworthy as part of the investment policy of the investment company. This relationship to General Investment Corporation started at the inception of the company when Albert E. Pierce & Company,<sup>167</sup> which Albert E. Pierce owned, undertook to distribute the common

<sup>163</sup> Id., Commission's Exhibit No. X4246 (pp. 74-77).

<sup>164</sup> Id., at 25367-8.

<sup>165</sup> Id., Commission's Exhibits Nos. X3970, X3424 (p. 61).

<sup>166</sup> Id., at 25573.

<sup>167</sup> Albert E. Pierce & Company is not to be confused with the New York Stock Exchange firm of E. A. Pierce & Co.

**TABLE 4.**—*Ultimate investments by General Investment Corporation by which it held control or joint control of the enterprises enumerated*

Name of security	Gross resources of company as per published balance sheets	Amount invested by General Investment Corporation	Nature of control or influence	Loss sustained
<i>Securities of companies which were sponsored by Albert E. Pierce &amp; Co. or for which the Pierce Company acted as distributor</i>				
Central Public Service Co. (including shares received in exchange for Central West Public Service costing \$1,558,187.26).	-----	\$8,097,644.35	Majority of voting trustees and ownership of about 48% of the outstanding common stock.	\$8,047,644.35
Central Public Service Corporation (exclusive of shares costing \$2,894,604.30 which were exchanged for shares of American Commonwealth Power Corporation).	\$364,127,426	8,470,803.33	Subsidiary of Central Public Service Co.	7,677,642.53
Consolidated Electric & Gas Co.	(a)	3,107,191.71	One of three voting trustees of stock all of which was owned by Central Public Utility Corporation, successor of Central Public Service Corporation.	2,786,066.71
American Commonwealth Power Corporation (including shares received at a cost of \$2,894,604.30 in exchange for shares of Central Public Service Corporation).	201,195,304	3,954,053.78	Owned about 22% of voting stock and had representation on board of directors.	3,705,667.12
<i>Securities which were eventually sold by General Investment Corporation to companies controlled or dominated by Albert E. Pierce</i>				
Portland Electric Power Co. (control of this company was acquired by General Investment Corporation through the purchases of a substantial majority of various of its capital securities at an aggregate cost of \$20,035,314.22. Of this, the preferred stocks and notes so acquired at a cost of \$8,221,374.86 were disposed of without profit or loss and the common shares costing \$11,813,939.36 were exchanged for securities of Central Public Service Co. and Corporation which were valued at \$13,950,000. This investment is included above in the respective Central Public Service Companies.)	(b)	-----	-----	-----

° See "Nature of Control."

¹ Included in consolidated resources of Central Public Service Corporation.

TABLE 4.—*Ultimate investments by General Investment Corporation by which it held control or joint control of the enterprises enumerated—Continued*

Name of security	Gross resources of company as per published balance sheets	Amount invested by General Investment Corporation	Nature of control or influence	Loss sustained
<i>Securities of companies which were sponsored by Albert E. Pierce &amp; Co. or for which the Pierce Company acted as distributor</i>				
Washington & Suburban Companies.	\$41,651,350	\$967,126.50	Together with sponsors owned almost 60% of the outstanding common shares.	\$967,125.50
Central West Public Service Co. (General Investment Corporation's investment in Central West Public Service Co. aggregated \$1,558,187.26 and was exchanged with Albert E. Pierce Investment Co. for voting trust certificates for common shares of Central Public Service Co. at cost. The \$1,558,187.26 is, therefore, included above in the \$8,097,644.35 investment in Central Public Service Co.).	21,961,534		50% of voting power	
<i>Others</i>				
Indiana Consumers Gas & By-Products Co.	6,294,295	2,396,883.33	Owned about 99.9% outstanding stock.	2,145,037.33
Cuba Company and Consolidated Railways of Cuba.	167,936,132	5,032,527.83	Owned about 27% of the Cuba Co. common stock which controlled Consolidated Rwy. of Cuba and had representation on board.	4,507,889.53
L'Union Electrique Rurale....	3,400,000	3,136,365.22	1/3 owned	2,646,922.78
Total.....	811,566,641	35,162,596.05		32,483,995.85

stock of the investment company paying for General Investment Corporation common stock with securities of the Central Public Service Corporation.<sup>168</sup>

During 1930 Albert E. Pierce & Company was the principal distributor of the common stock of General Investment Corporation, raising the entire \$2,756,184 cash paid in that year for securities issued by the investment company.<sup>169</sup> However, during the same year General Investment Corporation increased its investment in the inflated Central Public Service system<sup>170</sup> by about \$15,000,000, substantially all of which was eventually lost.<sup>171</sup> In 1931 General Investment Cor-

<sup>168</sup> See Table 3, *supra*, p. 506.

<sup>169</sup> *Ibid.*

<sup>170</sup> *Op. cit. supra*, note 1, at 25555-9.

<sup>171</sup> *Id.*, Commission's Exhibit No. N3969.

poration purchased from Albert E. Pierce & Company American Commonwealths Power Corporation stock for \$2,894,000, after which American Commonwealths Power Corporation almost immediately went into receivership.<sup>172</sup>

On the other hand, during 1930 Albert E. Pierce made a \$2,500,000 profit in terms of market value as the result of an exchange of stock with General Investment Corporation and with the Central Public Service Corporation, which Pierce sponsored but in which General Investment Corporation was at the time acquiring a \$15,000,000 investment (directly and indirectly through investment in Central Public Service Company, the parent of Central Public Service Corporation).<sup>173</sup>

Transactions with Albert E. Pierce took place again in 1935, when Albert E. Pierce purchased from General Investment Corporation for \$70,000 Central Public Service system stocks which had cost General Investment Corporation about \$15,795,000.<sup>174</sup> Thereupon, under the guidance of Mr. Devendorf, president of General Investment Corporation, Pierce almost immediately resold the stock at a profit of over \$100,000.<sup>175</sup>

Many of these investments as well as others made by General Investment Corporation and United States & Overseas Corporation, were acquired directly from their sponsors or from cobankers with Harris Forbes & Company in various utility enterprises. Mr. Burroughs testified that to some extent it was the intention of Harris Forbes & Company that such investment should further their own investment banking business:<sup>176</sup>

Q. \* \* \* In connection with your going into Public Utility Holding Corporation [General Investment Corporation] apart from the possible profits that were to be made through your investment in equities there was also the possibility, was there not, of financing that would accrue to Harris Forbes from your connections with public utility companies?

A. Oh, I suppose we had that in mind, but, of course, the Founders did not have that in mind.

Q. The Founders were not likely to get that kind of business; they were not an underwriting house.

A. No; but we could not get any benefits except that Founders would know all about, as they had a bigger interest in P. U. H. [Public Utility Holding Corporation later called General Investment Corporation] than Harris Forbes.

Q. Still, if Harris Forbes & Company did successfully put out certain issues the Founders Group could not share the profits from the financing fees that would come from those issues, would it?

A. I do not think, Mr. Stern, that we anticipated making new connections for Harris Forbes & Company and I do not know that we ever did make a new connection.

I do not think we thought that P. U. H. would build up an interest in equity of companies which Harris Forbes was handling bonds of, but I do not think that we looked on P. U. H. as an avenue for opening up new opportunities for Harris Forbes, but I think rather that the opposite was true.

<sup>172</sup> See note 383, *infra*. This stock was acquired in exchange for Central Public Service Corporation stock.

<sup>173</sup> *Op. cit. supra*, note 1, at 25616-7.

<sup>174</sup> *Id.*, Commission's Exhibit No. 3969.

<sup>175</sup> *Id.*, at 25636-8.

<sup>176</sup> *Id.*, at 25417.



Mr. Burroughs further testified that the use of the assets of an investment company by investment banker sponsors to aid in the expansion of the enterprises of their banking clients and thereby create new or additional banking business for the sponsors might be "unhealthy" from the viewpoint of the investment company.<sup>177</sup>

Q. This relationship and this activity in connection with \* \* \* Central Public Service and the relationship existing between Central Public Service and P. U. H. and Harris Forbes, was one in which a company which was managed by Harris Forbes was putting up junior money which provided the basis for senior financing which was used to buy more properties for the Central Public Service System, for which Harris Forbes was the banker.

A. I think that is correct.

Q. And the relationship, of course, was not too healthy a relationship for The Public Utility Holding Corporation [General Investment Corporation].

A. We thought it was a very good one.

Q. Let me put it this way. In the hands of bankers who were anxious to make a lot of money and who were not so careful how they made it, such a relationship would not be healthy for a company situated like P. U. H. [General Investment Corporation].

A. No; I suppose under those circumstances it would not be \* \* \*.

Although from its inception the assets of General Investment Corporation were utilized by Harris, Forbes & Company to aid in expansion programs of its own public utility holding company clients, the intention so to employ the funds of General Investment Corporation was not revealed to the public holders of its common stock until December 14, 1929. The original prospectuses stated only that the company had been formed "to buy, sell, and/or hold common stocks and/or other securities," and that it "will be the present policy of the directorate to limit the investments of the corporation to minority and/or controlling interests in securities of public utility companies, both foreign and domestic."<sup>178</sup> It was on December 14, 1929, only after at least 1,274,194 shares of the common stock of General Investment Corporation had been distributed to the public at an aggregate cost of \$36,847,388.83,<sup>179</sup> that a circular, signed by F. S. Burroughs, the president of the corporation, was issued which stated:<sup>180</sup>

\* \* \* The corporation is considered by many to be an investment trust. Definitely this is not the case, for unlike an investment trust which confines itself to investing a relatively small part of its capital in each of a highly diversified list of securities, it is the policy of Public Utility Holding Corporation to acquire relatively large interests in a comparatively few enterprises. In some cases control is acquired, while in other cases the objective is simply a large minority interest \* \* \*.

Control of utility companies will be acquired only in such cases as our management sees an opportunity (1) to revamp the capital structure so as to increase the earning power of the equity stock and therefore its value, whereupon it will be turned over to one of the group companies in which we already

<sup>177</sup> Id., at 2555X59.

<sup>178</sup> Id., Commission's Exhibit No. X3978.

<sup>179</sup> See Table 3, supra. As at December 24, 1929, there were more than 20,000 holders of the common stock and the average holding, exclusive of the blocks held by the sponsors, was less than 75 shares. (Id., Commission's Exhibit No. X3978.)

<sup>180</sup> Id., Commission's Exhibit No. X3978.

have an important interest, or to some group company in which we have no important interest in exchange for such an interest, or (2) to finance during a development period sound enterprises which cannot be advantageously financed in their own name during the development period.

However, this circular did not indicate that the described investment policies of General Investment Corporation might result in increasing the banking opportunities of Harris Forbes & Company, and of the interests associated with that firm in its investment banking activities for various utility enterprises. From 1929 to 1933, the period in which the General Investment Corporation and United States & Overseas Corporation were managed primarily by Harris Forbes & Company,<sup>181</sup> General Investment Corporation and United States & Overseas Corporation bought an aggregate of approximately \$107,000,000 of securities directly from the sponsors and their associates, which purchases were intended to increase the sphere of influence of or which in fact furthered the investment banking business of Harris Forbes & Company and their associates in the public utility field. The investment companies ultimately sustained a loss of approximately \$53,000,000 on these investments as indicated in Table 5.<sup>182</sup>

The aggregate of these purchases thus made by the two investment companies amounted to in excess of 10 times the net worth and in excess of 3 times the gross resources of Harris Forbes Companies at the middle of 1930.<sup>183</sup> The loss of \$52,300,000 of General Investment Corporation on these investments amounted to about 66% of the \$78,634,407.57 resources contributed to that investment company and accounted for about 74% of the \$70,604,248.43 loss in the operation of that investment company between 1929 and the middle of 1936.

These investments will now be briefly discussed.

## 1. WESTPHALIA UNITED ELECTRIC COMPANY—LOSS, \$3,156,612.54

The most substantial of the German credits loaned by United States & Overseas Corporation and General Investment Corporation was made in 1930 in participation with the Deutsche Bank to Westphalia United Electric Company. This investment resulted in a loss to the two American investment companies of \$3,156,612.54.<sup>184</sup> This loan was made to pay off a prior loan to the Westphalia company by the Deutsche Bank and others, and to complete a construction program of the electric company.

Whether the parts of the loan received from the two investment companies were used to pay Deutsche Bank or to complete the construction program and thereby provide the income for servicing the

<sup>181</sup> A majority of the board of directors, a majority of the executive committee, and the president of General Investment Corporation were all representatives of Harris Forbes Companies. (Id., Commission's Exhibit No. X3762.) Mr. Granbery of Harris Forbes Companies was president of United States & Overseas Corporation. (Ibid.)

<sup>182</sup> Table 5 was prepared from id., Commission's Exhibits Nos. X3423, X3424, X3962, X3969, X3970, X3983, X3996, X4000, X4111, and X4274.

<sup>183</sup> Public Examination, Eastern Utilities Investing Corporation, Commission's Exhibit No. 3845-D. In the middle of 1930, Harris Forbes Companies had \$33,500,000 gross assets (valued at cost or market, whichever was lower). Of these gross assets only \$9,752,929.67 was net capital and surpluses.

<sup>184</sup> Id., Commission's Exhibits Nos. X3970 and X3971.

TABLE 5.—*General Investment Corporation and United States & Overseas Corporation—Schedule of losses on major investments with respect to which the sponsors and their associates were directly or indirectly pecuniarily interested other than by reason of their interest in the purchasing investment company*

Company in which investment was made	Aggregate investments made and losses sustained by General Investment Corporation and United States & Overseas Corporation		Investments made by General Investment Corporation (including cost to General Investment Corporation of those acquired from United States & Overseas Corporation) and losses sustained		Investments made by United States & Overseas Corporation (exclusive of proceeds received from sales to General Investment Corporation) and losses sustained by United States & Overseas Corporation <sup>a</sup>	
	Investments	Loss (profit)	Investments	Loss (profit)	Investments	Loss (profit)
United States & Overseas Corporation	<sup>b</sup> \$12,451,493.54	\$2,761,598.39	\$12,451,493.54	<sup>c</sup> \$2,761,598.39		
General Investment Corporation	125,000.00	91,250.00			\$125,000.00	\$91,250.00
Portland Electric Power Co.	20,138,064.22	(2,099,260.64)	20,035,314.22	(2,136,060.64)	102,750.00	36,800.00
L'Union Electrique Rurale	3,136,365.22	2,646,922.78	3,136,365.22	2,646,922.78		
Consolidated Electric & Gas Corporation	3,107,191.71	2,786,066.71	3,107,191.71	2,786,066.71		
Central Public Service Co.	8,007,644.35	8,047,644.35	8,007,644.35	8,047,644.35		
Central Public Service Corporation	11,585,007.72	7,779,636.37	11,365,407.63	7,677,642.53	219,600.09	101,993.84
Washington and Suburban Companies	867,626.50	867,625.50	967,126.50	967,125.50	(99,500.00)	(99,500.00)
American Commonwealths Power Corporation	3,954,053.78	3,705,667.12	3,954,053.78	3,705,667.12		
Associated Gas & Electric Co. and its affiliates	15,579,496.31	14,636,562.67	15,327,881.91	14,437,828.53	251,614.40	198,734.14
General Gas & Electric Co.						
Eastern Utilities Investing Corporation.						
Buenos Aires Central Terminal and Railroad (and South American Rys.)	14,316,039.46	7,251,039.46	14,280,974.46	7,215,974.46	35,065.00	35,065.00
United States Electric Power Corporation	1,935,000.00	843,898.00	975,000.00	512,750.00	960,000.00	331,148.00
Westphalia United Electric Co.	7,140,961.50	3,156,612.54	7,140,961.50	3,156,612.54		
Elektrizitaetswerk Suedwest, A. G.	4,601,280.34	238,993.65	3,663,518.42	238,993.65	937,761.92	
Total	\$107,035,224.65	\$52,714,256.90	\$104,502,933.24	\$52,018,765.92	\$2,532,291.41	\$695,490.98

<sup>a</sup> In order to avoid duplication in the combined investment there has been included in the figures shown as investments by United States & Overseas Corporation aggregating \$2,532,291.41, the cost to United States & Overseas Corporation of those investments which were sold to purchasers other than General Investment Corporation, and only the loss sustained by United States & Overseas Corporation on sales made to General Investment Corporation, since these losses represent part of the original investment made by United States & Overseas Corporation. The loss of \$695,490.98 shown as realized by United States & Overseas Corporation included both losses sustained upon sales made to General Investment Corporation and to others.

<sup>b</sup> The amount of \$12,451,493.54 shown as the investment in United States & Overseas Corporation included only that portion of General Investment Corporation's investment in this company which is known to have been acquired from the sponsors of United States & Overseas Corporation.

<sup>c</sup> The loss of \$2,761,598.39 sustained by General Investment Corporation on the investment in United States & Overseas Corporation included an undeterminable portion of the losses shown as having been realized by United States & Overseas Corporation itself.

balance due to the Deutsche Bank in connection with the financing of the construction, it is apparent that an advantage was derived by the Deutsche Bank when the investment companies made these loans. Westphalia United Electric Company was a large electric company operating in southwestern Germany and served principally the cities of Munster, Bochum, and Dortmund. The Westphalia company, which acquired the stock of a number of municipally owned electric companies, was formed in 1926 and 1927 largely through the efforts of Messrs. Hulse and Burroughs of Harris, Forbes & Company. The formation of the Westphalia company was partly financed in the United States by a first mortgage bond issue distributed by Harris, Forbes & Company and Speyer & Co.<sup>185</sup> The newly formed Westphalia company thereafter undertook a heavy construction program which was financed temporarily by German banks, including the Deutsche Bank.<sup>186</sup>

In June 1930, Dr. Kehl of the Deutsche Bank, arranged with Mr. Burroughs, of Harris, Forbes & Company, for additional financing of Westphalia United Electric Company through the sale of debentures junior to the outstanding first mortgage bonds.<sup>187</sup> The proceeds of this issue were used to pay off the bank loans of the Westphalia Company. Mr. Burroughs testified:<sup>188</sup>

Q. And the proceeds were used in part at least to pay off the Deutsche Bank, were they not?

A. Certainly they were used to pay all of their bank loans, but what percentage of it was Deutsche I do not recall.

Q. You, I take it, recommended the Westphalia investment to Public Utility Holding Corporation?

A. Oh, yes; I was very enthusiastic about it. I not only formally recommended it, but I more than recommended. I urged and negotiated it. I thought it was a grand opportunity for P. U. H. [General Investment Corporation].

Deutsche Bank agreed with Westphalia United Electric Company to form a syndicate to underwrite \$15,000,000 of 6½% unsecured debentures, payable in dollars, due January 1934, convertible into preferred stock, at 92%.<sup>189</sup> Of this issue a syndicate headed by Deutsche Bank purchased \$7,250,000, and on the advice of the Harris Forbes organization,<sup>190</sup> General Investment Corporation purchased \$7,500,000, of which about one-third was allotted to United States & Overseas Corporation.<sup>191</sup> In addition, United States & Overseas Corporation directly purchased \$250,000 of these debentures.<sup>192</sup> In August 1931, General Investment Corporation purchased the holdings of United States & Overseas Corporation at cost,<sup>193</sup> thereby increasing the investment of General Investment Corporation in these debentures to \$7,140,961.50.<sup>194</sup> Although the Westphalia United Electric Company was supposed to have "had great prospects"<sup>195</sup> and "as

<sup>185</sup> Id., Commission's Exhibit No. X3972.

<sup>186</sup> Id., at 25394-5.

<sup>187</sup> Ibid.

<sup>188</sup> Ibid.

<sup>189</sup> Id., Commission's Exhibit No. X3968.

<sup>190</sup> Id., at 25395.

<sup>191</sup> Id., Commission's Exhibit No. X3970.

<sup>192</sup> Id., at 25391.

<sup>193</sup> Id., Commission's Exhibits Nos. X3970 and 3966 (p. 74).

<sup>194</sup> Id., Commission's Exhibit No. X3970.

<sup>195</sup> Id., at 25395.

a domestic enterprise it has been a great success,"<sup>196</sup> difficulties in getting in foreign exchange were encountered,<sup>197</sup> rendering the investment unprofitable. On March 14, 1934, General Investment Corporation sold the Westphalia United Electric Company debentures for \$3,984,348.96, either to Deutsche Bank, the German government, or the issuing company,<sup>198</sup> and sustained a realized loss of \$3,156,612.54 on that investment.<sup>199</sup>

## 2. ELEKTRIZITAETSWERKE SUEOWEST A. G.—LOSS, \$3,025,060.36

Included in the assets of United States & Overseas Corporation which were eventually acquired by General Investment Corporation by its exchange offer of its shares for the shares of United States & Overseas Corporation, were substantial loans made to Elektrizitaetswerke Suedwest A. G., a German utility company, and loans made to a syndicate headed by Deutsche Bank, a sponsor of United States & Overseas Corporation, in connection with the sale of control of Elektrizitaetswerke Suedwest A. G. On these investments, General Investment Corporation ultimately sustained a loss of \$3,025,060.36.

In 1929, three electric companies operated in Berlin, the second largest company being Elektrizitaetswerke Suedwest A. G., which was owned partly by the City of Berlin and partly by Gesellschaft Fuer Elektrische Unternehmungen, a German utility holding and operating company, commonly referred to as Gesfuereel. Late in the fall of 1929, when the City of Berlin was in financial difficulties,<sup>200</sup> officials of Gesfuereel, the Deutsche Bank, and Harris Forbes & Company determined to purchase the City of Berlin's interest in electric properties and also in gas and water properties. Pending the purchase of the City's electric properties, Deutsche Bank formed a syndicate participated in principally by German banks, and loaned the funds of the syndicate to Gesfuereel, which in turn loaned the funds to the City of Berlin and accepted as collateral the City of Berlin's holdings of Suedwest stock.<sup>201</sup> In this loan United States & Overseas Corporation participated, as at the end of March 1930, to the extent of \$1,166,605.38.<sup>202</sup>

Thereafter, Gesfuereel completed negotiations for the purchase of the City of Berlin's interest in Suedwest. This required an expansion of the original syndicate fund.<sup>203</sup> On April 30, 1930 United States & Overseas Corporation took a 9% participation in this second syndicate, thereby increasing its interest to \$1,494,088.63 on the basis of cost. Subsequently, this participation of United States & Overseas Corporation was reduced, without profit or loss, to \$556,326.71. This balance was acquired by General Investment Corporation at cost<sup>204</sup> in the process of liquidating United States & Overseas Cor-

<sup>196</sup> Id., at 25395.

<sup>197</sup> Ibid.

<sup>198</sup> Id., at 25394.

<sup>199</sup> Id., Commission's Exhibit No. X3970.

<sup>200</sup> Id., at 25372.

<sup>201</sup> Id., at 25372-3.

<sup>202</sup> Id., Commission's Exhibit No. X3962 (p. 33).

<sup>203</sup> Id., at 25373.

<sup>204</sup> Id., Commission's Exhibits Nos. X3962 (p. 33) and X3970.

poration.<sup>205</sup> On February 10, 1933, General Investment Corporation disposed of this investment by selling it to Gesfuerel for \$317,333.06, realizing thereby a loss of \$238,993.65.<sup>206</sup>

At the time the second Suedwest syndicate was formed additional funds were loaned directly to Suedwest by a third syndicate to permit advance payment of franchise taxes to the City of Berlin and the purchase of an extension of the company's franchise. This loan was to be exchangeable on the demand of the Deutsche Bank as syndicate manager into a 15- or 20-year debenture issue.<sup>207</sup> At the time, it was contemplated that part of this loan would be funded by an American offering of Suedwest debentures through Harris Forbes & Company.<sup>208</sup> In this loan to Suedwest, United States & Overseas Corporation directly participated by purchasing \$925,000 principal amount of the debentures of Suedwest<sup>209</sup> at a price of 112% of their face value.

However, on May 2, 1930, Harris Forbes & Company ceded to United States & Overseas Corporation a "further participation of \$1,840,000 principal amount of said debentures" at a price of 112% of their face value and agreed that it would (although it never did) "on or before June 30, 1930, repurchase these \$1,840,000 of debentures" from United States & Overseas Corporation at cost.<sup>210</sup> This purchase from Harris Forbes & Company increased the total investment of United States & Overseas Corporation in the Suedwest debentures to \$3,107,191.<sup>211</sup>

E. Carleton Granbery, of Harris Forbes & Company, and the president of United States & Overseas Corporation, testified that Harris Forbes & Company was unwilling to take a commitment in the loan made to Suedwest prior to the issuance by the company of definitive debentures in \$1,000 denominations which could be resold to the public. It was expected that definitive debentures would be issued by Suedwest on June 1, 1930. Mr. Granbery testified:<sup>212</sup>

\* \* \* At the time that I was having discussions with Dr. Kehl [of the Deutsche Bank, one of the sponsors of United States & Overseas Corporation] in Berlin, I told him that Harris Forbes & Company could not take a commitment for the debentures in their then form for at that time \* \* \* it was just a note on the Deutsche Bank and were not in the form of \$1,000 pieces, and so I discussed with Dr. Kehl whether it would be good business for U. S. & Overseas to purchase through Harris Forbes & Company the debentures in their then form and we agreed that it would be good business.

Consequently the U. S. & Overseas purchased about \$2,700,000 face amount of these debentures at \$110 or \$112 which as he said previously, were repayable at \$125. The form in which United States & Overseas bought the debentures was in the form of this book credit. I recall it as a loan on the books of the Deutsche Bank. The understanding was \* \* \* that the permanent debentures would be delivered about the first of June.

<sup>205</sup> Id., at 25383-4.

<sup>206</sup> Id., Commission's Exhibit No. X3970.

<sup>207</sup> Id., at 25374.

<sup>208</sup> Id., at 25374-5.

<sup>209</sup> Id., Commission's Exhibit No. X3967.

<sup>210</sup> Ibid.

<sup>211</sup> Id., Commission's Exhibit No. X3962.

<sup>212</sup> Id., at 25375-6.

The United States & Overseas took up and paid for this loan and the Harris Forbes & Company and United States & Overseas entered into an agreement by which Harris Forbes & Company agreed to buy on or before June 30, 1930, about \$1,800,000 of the debentures and United States & Overseas agreed to sell them.

Consequently, the assets of United States & Overseas Corporation, rather than the personal funds of Harris Forbes & Company, its sponsor, were consciously utilized as a means of acquiring and carrying securities which were a potential source of banking business and underwriting commissions to Harris Forbes & Company.

By June 30, 1930, no definitive debentures had as yet been issued by Suedwest.<sup>213</sup> On September 15, 1930, United States & Overseas Corporation, "in view of the fact that said debentures are not ready for delivery and cannot now be marketed," extended to December 31, 1930, the time for the repurchase of the debentures by Harris Forbes & Company.<sup>214</sup> Because of a change in German law, Suedwest was never able to issue debentures in a form salable to the public.<sup>215</sup> On December 31, 1930, Harris Forbes & Company did not repurchase from United States & Overseas Corporation its participation in the debentures. On June 24, 1931, in response to a letter from United States & Overseas Corporation requesting that Harris Forbes & Company confirm to Haskins & Sells, the corporation's accountants, its agreement to repurchase the debentures, Harris Forbes & Company stated that it "was unable to confirm" the agreement.<sup>216</sup> Mr. Granbery, of Harris Forbes & Company, and the president of United States & Overseas Corporation, testified that Harris Forbes & Company had construed its repurchase contract as an agreement to repurchase definitive debentures of Suedwest and that in the absence of the issuance of such debentures it had no obligation on its contract:<sup>217</sup>

Q. Mr. Granbery, in connection with this Exhibit 3967, Harris Forbes confirms to United States & Overseas \* \* \* "That we have ceded to you and you have accepted a further participation of \$1,840,000 principal amount of said debentures." Did I understand you to say that Harris Forbes didn't own anything at that time?

A. I never said that.

Q. Did Harris Forbes at that time have a participation in a syndicate that it was ceding, or what was it that it was ceding?

A. It was ceding the participation in this syndicate with Deutsche Bank.

Q. I see. Then the question, the next question that comes up, is that, "That on our part," Harris Forbes' part, "we agree that we will on or before June 30 repurchase these \$1,840,000 of debentures." That is what they have just ceded to you?

A. No.

Q. They have ceded a participation.

A. And we were to buy the debentures.

Q. They ceded the participation and agreed to buy debentures?

A. Yes.

<sup>213</sup> Id., at 25376.

<sup>214</sup> Id., Commission's Exhibit No. X3967.

<sup>215</sup> Id., at 25375-6.

<sup>216</sup> Ibid.

<sup>217</sup> Id., at 25378-9.



Mr. Granbery also testified: <sup>218</sup>

Q. \* \* \* Now, referring to the letter of June 24, 1931, to Harris Forbes & Company, this calls upon Harris Forbes & Company to in effect acknowledge the existence of their outstanding obligation to take back the \$1,840,000 of principal amount of debentures.

A. Yes, sir.

Q. And also ask them to state the amount of accrued interest due under that obligation. Then the next letter, June 24, 1931, is a disavowal by Harris Forbes that there is any such obligation.

A. Yes, sir.

Q. Now, up to this point, Mr. Granbery, and without wishing to go into the events of a controversy that may be in litigation, I take it that United States & Overseas on the one hand assumed that they had an obligation of Harris Forbes to repurchase and on the other hand Harris Forbes discriminated between the obligation to take over the participation and claimed that it was only obligated to take over the debentures; that was the net difference?

A. I would say that the auditors raised the point, Haskins & Sells.

Q. And Harris Forbes disclaimed any obligation?

A. Yes, sir.

On August 27, 1931, Mr. Granbery, of Harris Forbes & Company, as president of United States & Overseas Corporation, contracted with Mr. Addinsell, of Harris Forbes & Company, as vice president of General Investment Corporation, to sell to General Investment Corporation its holdings of Suedwest debentures and participations therein, including the participation ceded to it by Harris Forbes & Company for \$3,107,191.71, their cost to United States & Overseas Corporation.<sup>219</sup> However, whatever rights United States & Overseas Corporation had to compel Harris Forbes & Company to fulfill its repurchase agreement were not assigned to General Investment Corporation.<sup>220</sup>

It is significant that neither United States & Overseas Corporation nor General Investment Corporation ever made a demand upon Harris Forbes & Company to fulfill its repurchase obligation.<sup>221</sup> Whatever may have been the legal liability of Harris Forbes & Company either to General Investment Corporation or United States & Overseas Corporation in connection with this repurchase agreement and the transactions which have been described, the control by Harris Forbes & Company of both General Investment Corporation and United States & Overseas Corporation <sup>222</sup> enabled it during the period

<sup>218</sup> Id., at 25380.

<sup>219</sup> Id., Commission's Exhibit No. X3967.

<sup>220</sup> Id., at 25382-3.

<sup>221</sup> Mr. Granbery testified (id., at 25387):

Q. Mr. Granbery, referring to Exhibit 3967, which is the agreement in connection with Suedwest, and as part of that agreement, the agreement on the part of Harris Forbes to repurchase debentures as I understood you this morning you interpreted the agreement to mean that Harris Forbes had no obligation to repurchase anything except debentures?

A. After June 30 and after the extension.

Q. After June 30, 1930, and after the extensions?

A. Yes.

Q. Did United States & Overseas make any demand on Harris Forbes to repurchase these debentures?

A. No, sir.

<sup>222</sup> By December 31, 1930, United States & Overseas Corporation was virtually a wholly owned subsidiary of General Investment Corporation. (See *supra*, pp. 521-5.) At the same date a majority of the board of directors of General Investment Corporation consisted of members of Harris, Forbes & Company. (Id., Commission's Exhibit No. X3762.)



of its control of the two investment companies to prevent any judicial test by such companies of its liability to either or both of them.<sup>223</sup>

In 1932 General Investment Corporation exchanged all its holdings of and participations in Suedwest debentures, which it had acquired from its subsidiary, United States & Overseas Corporation at a cost of \$3,107,191.71, for a block of the common and preferred stock of Consolidated Electric and Gas Company.<sup>224</sup> The latter securities were sold in 1936 for \$321,125. General Investment Corporation therefore realized a loss of \$2,786,066.71 on its investment in the Suedwest debentures in addition to the \$238,993.65 loss which it had realized in the Suedwest stock syndicate.<sup>225</sup>

### 3. FRENCH FINANCING—LOSS, \$2,948,302.78

The participation of General Investment Corporation and United States & Overseas Corporation in the field of European finance was not limited to Germany. An arrangement similar to that existing between these investment companies and Deutsche Bank was sought in France. Mr. Burroughs testified:<sup>226</sup>

\* \* \* In Germany we thought it was a fine thing to work with the Deutsche Bank; in France we wanted to pick a similar group. \* \* \* In France it was a little difficult to find just the group we wanted to work with, but finally after studying the whole field we became acquainted with a group headed by the Marchena Brothers.

Through the Paris office of Harris Forbes & Company, Mr. Granbery was introduced to M. Marchena, the head of several operating power plants in France. Mr. Granbery attempted to persuade M. Marchena to permit General Investment Corporation and United States & Overseas Corporation to finance the Marchena properties.<sup>227</sup> However, M. Marchena was not prepared to have outside interests participate in the sponsorship of the electric properties he controlled. Instead, he suggested that these investment companies acquire an interest in electric power enterprises controlled by M. Loustou,<sup>228</sup> and promised to supervise the investment therein for the American investment companies.<sup>229</sup> As a result<sup>230</sup> investments were made by these investment companies in the Loustou-controlled L'Union Electrique Rurale<sup>231</sup> amounting eventually to \$3,136,365.22.<sup>232</sup> In addition,

<sup>223</sup> While this control did not preclude stockholders' suits on behalf of the investment companies, no such action was brought until 1937. In January 1938, General Investment Corporation, then controlled by Henderson Brothers of Boston, Massachusetts, joined in an action previously commenced by stockholders in 1937 (*Walter K. Bachrach and Frank A. Woodhead v. General Investment Corporation et al.*, United States District Court for the Southern District of New York, filed May 6, 1937) to recover from the stockholders of the former Harris Forbes Companies and others, damages for their alleged mismanagement of General Investment Corporation and United States & Overseas Corporation. (*Id.*, at 25527-8.)

<sup>224</sup> *Id.*, Commission's Exhibit No. X3970. Consolidated Electric and Gas Company sold the debentures during 1933 for proceeds of \$1,100,000. (*Id.*, Commission's Exhibit No. X4143.)

<sup>225</sup> *Id.*, Commission's Exhibit No. X3970.

<sup>226</sup> *Id.*, at 25397.

<sup>227</sup> *Id.*, at 25385.

<sup>228</sup> *Id.*, at 25398.

<sup>229</sup> *Id.*, at 25399.

<sup>230</sup> *Id.*, at 25385.

<sup>231</sup> *Id.*, Commission's Exhibits Nos. X3973 and X3974.

<sup>232</sup> *Id.*, Commission's Exhibit No. X3970.

\$925,950.39 was invested by the American investment companies in Hydro Energie,<sup>233</sup> a finance company jointly controlled with Marchena.<sup>234</sup> On the sale of these investments, an aggregate loss of \$2,948,302.76 was realized by General Investment Corporation and United States & Overseas Corporation.<sup>235</sup>

#### 4. INVESTMENT IN ASSOCIATED GAS AND ELECTRIC COMPANY AND AFFILIATED COMPANIES—LOSS, \$14,437,128.53

General Investment Corporation invested \$15,327,881.91 in the securities of companies in the Associated Gas and Electric Company system and ultimately sustained a realized loss of \$14,437,128.53 or approximately 94% on these investments.<sup>236</sup> Substantially this entire investment was acquired directly from the sponsors of the investment company, Harris Forbes & Company and the United Founders Corporation group, and from Pyncheon & Company,<sup>237</sup> an investment banking firm which was one of the primary distributors of the junior securities of companies in the Associated Gas and Electric Company system.<sup>238</sup> Harris Forbes & Company itself was the "principal" investment banker distributing the senior securities of companies in the Associated Gas and Electric Company system.<sup>239</sup>

As previously indicated, between September 13, 1929, and September 16, 1929, The Harris Forbes Corporation and the United Founders Corporation group sold to General Investment Corporation securities of the Associated Gas and Electric Company system, for a total of \$9,081,070.51<sup>240</sup> their then market value. On September 30, 1929, General Investment Corporation acquired from Pyncheon & Company in exchange for 145,270 shares of its own common stock additional securities of the Associated Gas and Electric Company system, with a then market value of \$5,374,990.<sup>241</sup>

As the result of these acquisitions, General Investment Corporation at September 23, 1929, had an aggregate investment of \$14,455,060.51 in the following securities of the Associated Gas and Electric Company system:<sup>242</sup>

<sup>233</sup> Id., Commission's Exhibit No. X3982.

<sup>234</sup> Id., at 25405.

<sup>235</sup> Id., Commission's Exhibits Nos. X3970 and X3982. Mr. Burroughs testified that the investment in this company was made as the first step to working with the Marchena interests. (Id., at 25405.)

<sup>236</sup> Id., Commission's Exhibits Nos. X3969 and X3983. In addition, United States & Overseas Corporation, which was eventually merged into General Investment Corporation, recorded losses of \$198,734.14 on an investment of \$466,614.15 in the securities of the Associated Gas and Electric Company system. Some of these securities were sold to General Investment Corporation. (Id., Commission's Exhibits Nos. X3969 and X3962.)

<sup>237</sup> See Table 3, p. 506, and note 33, supra.

<sup>238</sup> Op. cit. supra, note 1, at 25548.

<sup>239</sup> See note 251, infra.

<sup>240</sup> See note 33, supra.

<sup>241</sup> Op. cit. supra, note 1, Commission's Exhibit No. X3424 (pp. 32-34). The securities acquired from Pyncheon & Company were: 25,000 shares of Associated Gas and Electric Company common stock; 25,000 shares of General Gas & Electric Corporation Class A common stock; and 50,000 Associated Gas and Electric Company debenture warrants. (Ibid.)

<sup>242</sup> Id., Commission's Exhibit No. X3969.

132,644 shares Associated Gas and Electric common-----	\$7, 969, 835. 51
3,526 shares Associated Gas and Electric Cl. A-----	246, 820. 00
1,000 rights to buy Associated Gas and Electric common-----	29, 980. 00
1,147 Associated Gas and Electric "A" debentures-----	79, 360. 00
109,400 rights to buy Associated Gas and Electric debentures----	2, 496, 700. 00
21,000 shares Eastern Utilities Investing Corp. Cl. A-----	584, 535. 00
25,000 shares General Gas & Electric Co. Cl. A-----	2, 624, 990. 00
4,000 shares General Gas & Electric Co. \$6 cum. prd., Ser. A-----	422, 840. 00
Total-----	14, 455, 000. 51

According to Erwin Rankin, the investment manager of the United Founders Corporation group,<sup>243</sup> utility stocks were inflated at the time of this purchase,<sup>244</sup> and, from an investment viewpoint, the securities of the Associated Gas and Electric Company system were particularly undesirable:<sup>245</sup>

Q. I believe a few minutes ago you said something about taking pride in the fact you didn't hold any Midwest and Associated Gas?

A. And Utilities Power and Light, those were the three.

Q. Did you have any particular reason for being proud about not having Associated Gas and Midwest other than the fact there was a market depreciation?

A. No: except the three companies were all pretty far-flung utility situations, top holding companies and from our investment angle we didn't think they were of the kind we should own.

Q. They were rather bad eggs in the utility holding basket——

A. You are putting it a little strong but there is a certain element of truth in it.

As has been shown, General Investment Corporation acquired 132,644 shares of the common stock of Associated Gas and Electric Company from its sponsors and Pynchon & Company, paying therefor \$7,969,835.51, the then quoted market value of the securities. This common stock was junior in its participation in the earnings and assets of Associated Gas and Electric Company to all of that company's other outstanding securities;<sup>246</sup> had no voting power<sup>247</sup> and, therefore, no control value; and had never paid any dividends.<sup>248</sup> At the end of 1929 there were no tangible assets applicable to these common shares (the stated value of Associated Gas and Electric Company common shares depended upon maintaining on the books of Associated Gas and Electric Company an excess of cost of its

<sup>243</sup> Id., at 24814-6.

<sup>244</sup> Id., at 24882-3.

<sup>245</sup> Id., at 24888-9.

<sup>246</sup> Associated Gas and Electric Company had outstanding as at December 31, 1929, \$251,461,293.50 face amount of debentures and notes (Report of the Federal Trade Commission on Utility Corporation, pursuant to S. Res. 83, 70th Cong., 1st Sess., Senate Doc. No. 92, Pt. 45, p. 1294); 5 issues of preferred stocks having a total liquidating preference of \$24,778,296 (id., at 1254 and *Poor's Manual of Public Utilities*, 1930, pp. 2143 and 2152); 5,817,371 shares of Class A common stock having a preference in dividends before the remaining issues of common stock of \$2 per share per annum; 500,000 shares of Class B common stock which carried the sole voting power in the corporation and which was entitled to a priority in dividends of \$2 per share before any payment of dividends to the common stockholders and 1,703,538 shares of common stock. (*Poor's Manual of Public Utilities*, 1930, pp. 2143-52.)

<sup>247</sup> *Poor's Manual of Public Utilities*, 1930, p. 2144.

<sup>248</sup> Ibid.

subsidiaries to it beyond the cost of their assets to the subsidiaries themselves.<sup>249</sup>

Of these shares of Associated Gas and Electric Company common stock, 51,144 shares were sold to General Investment Corporation by The Harris Forbes Corporation for an aggregate sales price of \$3,075,033.01.<sup>250</sup> Of these shares so sold by The Harris Forbes Corporation, 50,000 had been acquired by Harris Forbes & Company in 1926 from Associated Gas and Electric Company as a bonus to that firm for becoming the bankers for Associated Gas and Electric Company. Apparently it had been intended that The Harris Forbes organization would retain this bonus stock and thus have a continuing stock interest in the affairs of the Associated Gas and Electric Company system.<sup>251</sup> The sale of these bonus shares to General Investment Corporation gave The Harris Forbes Corporation a profit of about \$3,000,000; and The Harris Forbes Corporation, through their stock interest in General Investment Corporation, was able to retain a financial interest in these shares.

Substantially all of the 3,526 shares of the Class A common stock of Associated Gas and Electric Company acquired were purchased directly by General Investment Corporation from The Harris Forbes Corporation for \$246,820.00, their then market value.<sup>252</sup> However, the market price of these Class A shares, as Harris, Forbes & Company were or should have been aware, did not represent an independent market appraisal of the value of these shares by investors generally, but, rather, was a reflection primarily of market purchases of such shares by Associated Gas & Electric Securities Corporation, a subsidiary of the Associated Gas and Electric Company. One of the brokers effecting such purchases for the account of Associated Gas and Electric Securities Corporation was Harris, Forbes & Company.<sup>253</sup>

During the month of September 1929, when The Harris Forbes Corporation transferred the Class A shares of the Associated Gas and Electric Company to General Investment Corporation at their then

<sup>249</sup> Report of the Federal Trade Commission on Utility Corporations. Pt. 45, p. 140 et seq.

<sup>250</sup> See note 33, supra.

<sup>251</sup> Mr. Burroughs, of The Harris Forbes Corporation, testified (op. cit. supra, note 1, at 25449-50) :

A. That was the 50,000 shares Harris Forbes had received earlier—1926. I think, at the time, or about the time that it handled the Associated Electric bond issue and became the principal banker for Associated Gas & Electric System at that time, but not as part of that deal, but really for becoming identified with the financing, Harris Forbes & Company were given 50,000 shares of Associated Gas & Electric Company common \* \* \*.

Q. Were there any restrictions on the sale of that 50,000 shares?

A. No restrictions; no.

Q. You could have sold it the next day.

A. Well, I don't suppose it would be considered very nice to take a block of stock and immediately dump it on the market. The reason Harris Forbes were given that stock was so that they would have an interest in the corporations they were going to be identified with. It was quite a common thing for bankers to be given a bonus of stock at that time. It had been more common earlier, and has become very uncommon today.

<sup>252</sup> See note 33, supra.

<sup>253</sup> Report of the Federal Trade Commission on Utility Corporation, Pt. 64 (pp. 713-715). During 1929 the Associated Gas & Electric Securities Corporation's purchases on the New York Curb Exchange of the Class A stock of Associated Gas and Electric Company through brokers, including Harris, Forbes & Company, accounted for 68% of the total volume of trading in that stock on that exchange for the year. (Ibid.)

market value, purchases on the New York Curb Exchange of this stock by Associated Gas & Electric Securities Corporation accounted for 64% of the total volume of trading in the stock on that exchange.<sup>254</sup>

The 4,000 shares of the preferred stock of General Gas & Electric Corporation acquired by General Investment Corporation from the United Founders Corporation group at a cost of \$423,000<sup>255</sup> represented in substance only an interest in Associated Gas and Electric Company. In September of 1929, substantially the only assets of General Gas & Electric Corporation were the debentures and Class A common stock of Associated Gas and Electric Company.<sup>256</sup> And at that time—September of 1929—Harris Forbes & Company was engaged in distributing preferred stock of General Gas & Electric Corporation, the proceeds of which were utilized by General Gas & Electric Corporation to purchase additional blocks of the securities of Associated Gas and Electric Company.<sup>257</sup>

The 21,000 shares of the Class A common stock of Eastern Utilities Investing Corporation were acquired by General Investment Corporation for \$585,375 from the United Founders Corporation group.<sup>262</sup> This stock had been distributed during 1929 by Pyncheon & Company while Harris, Forbes & Company was distributing Eastern Utilities Investing Corporation debentures to which were attached warrants to purchase such Class A common stock.<sup>263</sup> The valueless nature of the Class A common stock of the Eastern Utilities Investing Corporation and the most substantial losses sustained by that company which was used merely as a medium of financing the Associated Gas and Electric Company system will be discussed in the subsequent section of this chapter detailing the history of Eastern Utilities Investing Corporation.

Ultimately General Investment Corporation invested \$15,327,881.92 in the securities of companies in the Associated Gas and Electric Company system, on which it realized losses on resale of \$14,437,828.53.<sup>264</sup> As has been indicated, a substantial part of the cost of the investment included a profit of \$3,000,000 to The Harris Forbes Corporation and a profit of \$1,239,835.14 to the United Founders Corporation group.<sup>265</sup> It is significant that at the time of the purchase of these Associated Gas and Electric Company system securities, Harris, Forbes & Company was represented by nominees to the boards of directors of the various companies in the Associated Gas and Electric Company system, including Frederick S. Burroughs, who also served as the president and a director of General Investment Corporation.<sup>266</sup>

<sup>254</sup> *Id.*, at 715. Substantial blocks of the Class A stock of the Associated Gas and Electric Company purchased on the New York Curb Exchange market by Associated Gas and Electric Securities Corporation were resold off the market through dealers. These sales therefore did not affect the market price of the shares on that exchange.

<sup>255</sup> See note 33, *supra*.

<sup>256</sup> For a more detailed discussion of the General Gas & Electric Corporation's holdings of Associated Gas and Electric Company securities, see the detailed history of Eastern Utilities Investing Corporation. See XI of this chapter, *infra*, p. 624 et seq.

<sup>257</sup> *Ibid.*

<sup>258</sup> See note 33, *supra*.

<sup>263</sup> *Op. cit. supra*, note 1, at 25452.

<sup>264</sup> See note 236, *supra*.

<sup>265</sup> See notes 33 and 251, *supra*.

<sup>266</sup> See the story of Eastern Utilities Investing Corporation. See XI, *infra*, p. 624 et seq.

## 5. INVESTMENT IN UNITED STATES ELECTRIC POWER CORPORATION—LOSS, \$849,550

On September 10, 1929, United Founders Corporation and Harris Forbes & Company, among others, caused the formation of United States Electric Power Corporation, a utility holding company.<sup>267</sup> The Harris Forbes Corporation on September 17, 1929, acquired from United States Electric Power Corporation 150,000 shares of its common stock at \$13.50 per share.<sup>268</sup> Payment therefor was made by United Founders Corporation by delivering to United States Electric Power Corporation a block of Standard Gas & Electric Company common stock. This block of Standard Gas & Electric common stock had been acquired by United Founders Corporation for the account of The Harris Forbes Corporation, but The Harris Forbes Corporation had not made payment prior to September 17, 1929.<sup>269</sup> On about the same day The Harris Forbes Corporation resold to General Investment Corporation 65,000 shares of United States Electric Power Corporation common stock at a price of \$15 per share for total proceeds of \$975,000<sup>270</sup> and resold to United States & Overseas Corporation 30,000 of such shares at the same price for total proceeds of \$450,000.<sup>271</sup> On the shares so sold, The Harris Forbes Corporation derived a total profit of \$142,500 without the prior expenditure of any of its own funds.

This profit to The Harris Forbes Corporation could not have been realized by selling the United States Electric Power Corporation common stock in the open market, for at the time of the sales The Harris Forbes Corporation was under contract with Founders General Corporation and others not to sell any of these shares of United States Electric Power Corporation common stock before October 20, 1929.<sup>272</sup> The United States Electric Power Corporation common stock which was sold to General Investment Corporation at \$15 per share were the securities of a company which had been in existence but one week,<sup>273</sup> and had an asset value of only \$12.28 per share.<sup>274</sup>

Ultimately General Investment Corporation sustained a loss of \$512,750,000<sup>275</sup> and United States & Overseas Corporation, prior to its acquisition by General Investment Corporation, sustained a loss of \$336,800,<sup>276</sup> on their respective investments in the common stock of United States Electric Power Corporation.

The investment in United States Electric Power Corporation made by General Investment Corporation and United States & Overseas

<sup>267</sup> *Op. cit. supra*, note 1, at 26113-26117.

<sup>268</sup> *Id.*, Commission's Exhibit No. X3422 (p. 9).

<sup>269</sup> *Id.*, Commission's Exhibit No. X4021.

<sup>270</sup> *Id.*, Commission's Exhibits Nos. X3980 and X3969.

<sup>271</sup> *Id.*, Commission's Exhibit No. X3962.

<sup>272</sup> *Id.*, Commission's Exhibit No. X4025. Founders General Corporation was the principal distributing agent of United States Electric Power Corporation.

<sup>273</sup> *Id.*, Commission's Exhibit No. X4018 (p. 19).

<sup>274</sup> On September 17, 1929, United States Electric Power Corporation first acquired assets by issuing or contracting to issue 2,000,000 shares of Class A stock and 3,728,340 shares of common stock, entitled to equal participation in assets and earnings (*id.*, Commission's Exhibit No. X4019) for \$70,332,590 or an average price of \$12.28 per share. (*Id.*, Commission's Exhibit No. X3422, p. 9.)

<sup>275</sup> *Id.*, Commission's Exhibit No. X3969.

<sup>276</sup> *Id.*, Commission's Exhibit No. X3962 (p. 28).

Corporation was not limited to common stock, for these investment companies purchased from The Harris Forbes Corporation preferred stock of United States Electric Power Corporation for \$1,020,000, thereby relieving The Harris Forbes Corporation of the burden of holding the preferred stock pending a propitious time for its distribution. On November 7, 1929, The Harris Forbes Corporation had agreed to purchase from the United Founders Corporation group a large block of newly issued United States Electric Power Corporation preferred stock at the issue price of \$85 per share in contemplation of a public distribution.<sup>277</sup> By the end of 1929 The Harris Forbes Corporation had sold to General Investment Corporation and United States & Overseas Corporation an aggregate of 12,000 shares at the same price of \$85 per share for a total of \$1,020,000,<sup>278</sup> thereby reducing by that amount the outlay of The Harris Forbes Corporation in this financing. The United States Electric Power Corporation preferred stock was held by the two investment companies until the middle of 1930, when the plan of public distribution of preferred stock was abandoned,<sup>279</sup> and the shares were retired by United States Electric Power Corporation<sup>280</sup> without loss to the two investment companies.<sup>281</sup>

#### 6. INVESTMENT IN CENTRAL PUBLIC SERVICE COMPANY SYSTEM—LOSS, \$21,534,751.73: AND PORTLAND ELECTRIC POWER COMPANY—PROFIT, \$2,136,060.64

The largest investment of General Investment Corporation aggregating \$22,570,243.69, was made in the stock of companies of the Central Public Service system.<sup>282</sup> This investment was acquired principally from three sources: The Harris Forbes Corporation at the inception of General Investment Corporation; Albert E. Pierce & Company,<sup>283</sup> sponsor of Central Public Service Company; and by the exchange of General Investment Corporation's controlling interest in Portland Electric Power Company with Central Public Service Corporation and Albert E. Pierce for stock of both Central Public Service Company and Central Public Service Corporation.

On resale of the \$22,570,031.98 investment, General Investment Corporation realized losses of \$21,395,957.89 or over 94% of its aggre-

<sup>277</sup> Id., Commission's Exhibit No. X4060. In a collateral agreement of the same date United States Electric Power Corporation agreed to indemnify The Harris Forbes Corporation against loss in the event of distribution at a loss.

<sup>278</sup> Id., Commission's Exhibits Nos. X3969 and X3962 (p. 28).

<sup>279</sup> Id., Commission's Exhibits Nos. X4073 and X4074.

<sup>280</sup> Id., Commission's Exhibit No. X3422 (p. 9).

<sup>281</sup> Id., Commission's Exhibits Nos. X3969 and X3962 (p. 28).

<sup>282</sup> Id., Commission's Exhibits Nos. X3969 and X3970. This investment consisted of the following securities:

Central Public Service Company-----	\$6, 539, 437. 09
Central West Public Service Company which was exchanged for Central Public Service Company-----	1, 558, 187. 26
Central Public Service Corporation-----	11, 365, 407. 63
Consolidated Electric and Gas Corporation received for Elektrizitäts- werke Suedwest debentures costing-----	3, 107, 191. 71

<sup>283</sup> Albert E. Pierce & Company should not be confused with E. A. Pierce & Co., members of the New York Stock Exchange.



gate investment.<sup>284</sup> The most substantial part of these losses was realized on resale of the securities to the Pierce interests.<sup>285</sup>

Approximately \$13,950,000 of the total investment of General Investment Corporation in Central Public Service Company and its subsidiary, Central Public Service Corporation, was the result of the exchange of General Investment Corporation's controlling interest in Portland Electric Power Company for the securities of Central Public Service Company and Central Public Service Corporation. In September 1929, almost immediately after its formation, General Investment Corporation was caused to contract to purchase control of the Portland Electric Power Company,<sup>286</sup> a company which, through subsidiaries, operated street railways, gas, electric, and water companies in Portland and other Oregon cities.<sup>287</sup> Negotiations for this sale were initiated by C. Sewell Clark, of E. W. Clark & Company, of Philadelphia, which had formed Portland Electric Power Company<sup>288</sup> and held a controlling stock interest therein,<sup>289</sup> in response to an offer then being made generally to the public by General Investment Corporation to exchange its common stock for the stock of a number of Pacific Coast utility companies including Portland Electric Power Company.<sup>290</sup>

The sale of Portland Electric Power Company was not without its attractions to E. W. Clark & Company, which was "depression minded" at the time and did not desire to hold the unlisted securities of Portland Electric Power Company.<sup>291</sup> C. Sewell Clark, of E. W. Clark & Company, testified that the property had been a "headache" to E. W. Clark & Company for a number of years,<sup>292</sup> and that E. W. Clark & Company had had to guarantee an issue of \$4,000,000 of the

<sup>284</sup> Id., Commission's Exhibits Nos. X3969 and X3970. The losses were realized as follows:

Central Public Service Company-----	\$8, 047, 624. 35
Central Public Utility Corporation (received in exchange for Central Public Service Corporation)-----	7, 677, 642. 53
Consolidated Electric and Gas Corporation-----	2, 786, 066. 71
American Commonwealths Power Corporation (received in exchange for Central Public Service Corporation)-----	2, 884, 604. 30

As will be discussed hereinafter, included in the costs is \$2,136,060.64 profit recorded on exchanging Portland Electric Power Corporation stock for Central Public Service System stock. Also included in the cost are losses of about \$2,000,000 on Elektrizitatswerke Suedwest debentures and of about \$152,000 on Central West Public Service Company unrecorded at the time of exchange for Central Public Service System securities.

<sup>285</sup> Id., Commission's Exhibit No. X3969.

<sup>286</sup> Id., Commission's Exhibit No. X4114.

<sup>287</sup> Id., Commission's Exhibit No. X4117. As at December 31, 1929, Portland Electric Power Company had outstanding 64,608 shares of 7% cumulative \$1,000 par value prior preference stock; 31,800 shares of 7.2% \$100 par value cumulative first preferred stock; 58,898 shares of \$100 par value 6% cumulative first preferred stock; 39,092 shares of 6% no par value cumulative first preferred stock; 55,000 shares of 6% \$100 par value noncumulative second preferred stock; 413 shares of common stock of the par value of \$100 per share; and 149,587 shares of no par value common stock. In addition, the company and its subsidiaries had outstanding as at December 31, 1929, bonds and notes of the aggregate principal amount of approximately \$44,500,000. (*Poor's Manual of Public Utilities*, 1930, at 959.) In 1935 Portland Electric Power Company went into reorganization.

<sup>288</sup> Op. cit. supra, note 1. Commission's Exhibit No. X4247 at pp. 3 and 6.

<sup>289</sup> Id., at 25535 (testimony of F. S. Burroughs).

<sup>290</sup> Id., Commission's Exhibit No. X4247 at 21.

<sup>291</sup> Id., Commission's Exhibit No. X4247 at 20.

<sup>292</sup> Ibid., at 25-27.



notes of Portland Electric Power Company to keep the company solvent. Furthermore, the rate schedules of the company were among the lowest in the United States, only three being lower.<sup>293</sup> In addition, the financial history of the company had not been too successful. On at least two occasions the company had been compelled to raise additional capital by offering second preferred stock to its common stockholders in exchange for common stock and cash. The company also had been required to issue about \$500,000 of its second preferred stock in settlement of a law suit.<sup>294</sup>

As a result of the negotiations between the parties on September 24, 1929 a contract was executed between General Investment Corporation and E. W. Clark & Company providing for the tender to General Investment Corporation of substantially all the outstanding junior preferred stock and common stock of Portland Electric Power Company for payment in cash or General Investment Corporation common stock at the option of the sellers. General Investment Corporation was privileged to reject the tenders if less than a controlling interest was tendered.<sup>295</sup> C. Sewell Clark of E. W. Clark & Company succeeded in negotiating in this exchange a price of \$80 per share for the Portland Electric Power Company common stock.<sup>296</sup> This price was \$15 per share above the prevailing market price for the stock<sup>297</sup> and about forty times the annual earnings<sup>298</sup> of Portland Electric Power Company. The working capital of Portland Electric Power Company was apparently inadequate for corporate requirements. Within two months after the acquisition of control of Portland Electric Power Company, General Investment Corporation and United States & Overseas Corporation had to lend \$1,000,000 to the electric company to meet the payment of interest on its outstanding debentures.<sup>299</sup>

In all, General Investment Corporation acquired 148,936 of common shares, 51,246½ of second preferred shares, 20,384 of 6% first preferred shares, 5,447 of 7% prior preferred shares, and 10 of 7.2% first preferred shares of Portland Electric Power Company at a cost of about \$19,035,314.22.<sup>300</sup> Of this amount, \$1,731,188.43 was paid for by the issuance of 47,165 shares of General Investment Corporation common stock<sup>301</sup> and the balance of \$17,304,125.79, was paid in cash.

The investment thus acquired by General Investment Corporation constituted about 30% of the then total assets of the investment company on December 31, 1929.<sup>302</sup> According to Mr. Burroughs, president of General Investment Corporation, the fact that this

<sup>293</sup> *Ibid.*

<sup>294</sup> *Ibid.*

<sup>295</sup> *Id.*, Commission's Exhibit No. X4114.

<sup>296</sup> *Id.*, Commission's Exhibit No. X4247 at 24.

<sup>297</sup> *Id.*, at 25535-6. However, this market price was for nominal amounts of stock only. (*Ibid.*)

<sup>298</sup> *Id.*, at 25534-5 and Commission's Exhibit No. X4117. While admitting that \$80 per share was a "pretty good price to get out on" C. Sewell Clark thought the price was possibly justifiable on the basis of a potentially high rate of earnings incidental to the pyramided capital structure of the company. (*Id.*, Commission's Exhibit No. X4247 at 25.)

<sup>299</sup> *Id.*, Commission's Exhibit No. X4119.

<sup>300</sup> *Id.*, Commission's Exhibits Nos. X3969 and X4101.

<sup>301</sup> *Id.*, Commission's Exhibit No. X3424 at 32-34.

<sup>302</sup> *Id.*, Commission's Exhibit No. X3424 at 5.

investment lacked marketability<sup>303</sup> was of slight concern to the management of General Investment Corporation:<sup>304</sup>

Public Utility Holding Corporation was not primarily concerned with the marketability of its holdings. It bought as stated in its Articles, for long-term investment without thought of resale. That was our idea. It might have been wrong. We were not thinking of getting into the business of trading in securities; we wanted to buy stocks we thought we could put in the portfolio and hold and they would go along and enhance in value.

Mr. Burroughs testified that Portland Electric Power Company securities were acquired by General Investment Corporation as an investment and with confidence that the management of the utility company was already in capable hands requiring no supervision by General Investment Corporation.<sup>305</sup>

Q. Just what was the purpose of acquiring Portland Electric?

A. The purpose was that we thought it was a good company and we could buy it on a basis that worked out about a 7% return on our investment. It was one of the few large independent public utility system in the country not in any holding-company group, and we believed it was a very desirable investment, and I still think it is a very desirable investment. I think it is too bad it was disposed of. I think it is a grand company. I think it is unfortunate that P. U. H. [General Investment Corporation] did not retain it, and now own it.

Q. \* \* \* How did you expect to operate an operating company?

A. The company had its own operating organization headed by one of the ablest men in the whole industry, and they considered the property didn't need any supervision other than that of Mr. Griffith and his organization. There was a difference of opinion among our P. U. H. directors. I was very enthusiastic about Portland; in fact, all of them were, but some of the directors felt that P. U. H. should not get into the business of owning 100% of the control of an operating property; that we should have a partner who was in the public utility business and we should stick to our original idea of owning a minority interest. There was a difference of opinion and that was the reason it was turned over to the Central Public Service.

Q. Just what did P. U. H. as a holding company contribute? They acquired control in the first instance, but they were not going to manage?

A. They were going to be a stockholder and felt that the Portland Electric Company had splendid management.

Q. So it was bought on the theory of an investment proposition?

A. That is right.

Q. Running to practically the total of the stock outstanding, pretty close to it?

A. That's right.

Q. And that represented about 30% or so of the capital raised by P. U. H. exclusive of the United States & Overseas?

A. I haven't calculated that, but I think that is about right.

Nevertheless, the investment represented a possibility of a resale privately to a utility operator or by public distribution.<sup>306</sup> Although the management of General Investment Corporation thought Portland

<sup>303</sup> Id., at 25533.

<sup>304</sup> Id., at 25532.

<sup>305</sup> Id., at 25530-2.

<sup>306</sup> Id., at 25532. Mr. Burroughs testified that it was intended to reclassify the common stock and second preferred stock of the utility company into one class of stock yielding a 7% return on the investment therein. (Id., at 25534-5.)

Electric Power Company was "a very desirable investment,"<sup>307</sup> this investment was resold within a short time partly because the holding of exclusive control of a utility company was contrary to the underlying policy of the investment company not to own more than joint control of companies in which investments were made.<sup>308</sup> On January 30, 1930, contracts were executed providing for the sale of Portland Electric Power Company by General Investment Corporation to Central Public Service Corporation, principally in exchange for the common stocks of Central Public Service Corporation and of its parent,<sup>309</sup> Central Public Service Company.<sup>310</sup> Pursuant to the contract of sale on March 14, 1930, General Investment Corporation sold its \$20,035,314.22 investment in Portland Electric Power Company, including the \$1,000,000 loan,<sup>311</sup> to Central Public Service Corporation for \$22,171,374.86, recording a profit of \$2,136,060.64.<sup>312</sup> Payment was made by Central Public Service Corporation as follows: \$8,221,374.86 in cash; \$4,200,000 by the transfer of 175,000 shares of Central Public Service Company common stock; and \$9,750,000 by the transfer of 300,000 shares Central Public Service Corporation Class A common stock.<sup>313</sup>

By this exchange General Investment Corporation became one of the two largest stockholders in the Central Public Service Company system.<sup>314</sup> Central Public Service Company in 1929 owned all of the common stock of Central Public Service Corporation,<sup>315</sup> which, in turn, through its subsidiaries controlled public utility companies operating in various parts of the United States and other countries.<sup>316</sup> A ma-

<sup>307</sup> Id., at 25530.

<sup>308</sup> Id., at 25531.

<sup>309</sup> Id., Commission's Exhibit No. X4101.

<sup>310</sup> Id., at 25616.

<sup>311</sup> Id., Commission's Exhibit No. X3969. This cost figure included the \$1,000,000 loan which General Investment Corporation and United States & Overseas Corporation had made to Portland Electric Power Company. (Id., Commission's Exhibits Nos. X4119, X4101, and X3969.)

<sup>312</sup> Ibid.

<sup>313</sup> Id., Commission's Exhibits Nos. X4101, X3969, and X4119.

<sup>314</sup> Id., Commission's Exhibit No. X3423-a, at 9.

<sup>315</sup> As at December 31, 1929, Central Public Service Company had outstanding 22,041 shares of \$7 preferred stock, having a preference in liquidation of \$100 per share and accrued dividends, and 213,816 shares of common stock. (Report of the Federal Trade Commission on Utility Corporations, pursuant to S. Res. No. 83, 70th Cong., 1st Sess., Document 92, Pt. 5, at 1057, 1063.) The chief asset of Central Public Service Company consisted of its holdings of all of the common stock of Central Public Service Corporation. (Ibid.) As at December 31, 1929, Central Public Service Corporation had outstanding the following securities: 190,961 shares of preferred stock of various classes; 1,603,478 shares of Class A stock, without voting power except on a default in four consecutive dividends, but entitled to receive dividends of \$1.75 per annum in priority to any payment of dividends on the common stock and also entitled on any liquidation of the company to a claim against assets in preference to the common stock of \$30 a share; and 1,000,000 shares of common stock, all of which were held by Central Public Service Company. (Id., at 891-2.) In addition, as at December 31, 1929, Central Public Service Corporation had outstanding approximately \$44,000,000 face amount of note debentures and other long-term debt. (*Poor's Manual of Public Utilities*, 1930, at 939-40.)

<sup>316</sup> The principal direct subsidiaries of Central Public Service Corporation as at December 31, 1929, were Central Gas & Electric Company, Central Public Utility Corporation, Federated Utilities, Inc., Southern Cities Public Service Company, and Southern Gas Securities Company. (Report of the Federal Trade Commission on Utility Corporations, pursuant to S. Res. No. 83, 70th Cong., 1st Sess., Document 92, Pt. 5, at 1007 [Chart of Central Public Service Company System].) The Central Public Service system supplied

jority of the common stock of Central Public Service Company, the top holding company, was held by A. E. Pierce, who also owned Albert E. Pierce & Company, a Chicago investment banking firm which acted as one of the principal distributors of stock for the system. It will be recalled that Albert E. Pierce & Company in 1930 also had acted as the principal distributor of the common stock of General Investment Corporation,<sup>317</sup> and Harris Forbes & Company in turn had acted as one of the principal bankers for this system of utility companies.<sup>318</sup>

General Investment Corporation's acquisition of its interest in the Central Public Service Company system by the exchange for Portland Electric Power Company was not that investment company's initial investment in the Central Public Service Company system. Almost immediately after its incorporation, between September 13 and September 16, 1929, General Investment Corporation was caused to purchase from its sponsors—principally The Harris Forbes Corporation—10,600 shares of the common stock of Central Public Service Company for \$741,996, and 10,100 shares of the Class A common stock of Central Public Service Corporation for \$506,225, or a total cost of \$1,248,221,<sup>319</sup> the then market value of these shares. In addition, during September 1929, General Investment Corporation acquired from Albert E. Pierce & Company 20,000 shares of Central Public Service Corporation Class A common stock for \$1,100,000 by exchanging therefor its own common stock at current market prices.<sup>320</sup>

The transfer of Portland Electric Power Company to Central Public Service Corporation resulted in approximately a 33% expansion in the Central Public Service Company system. The system acquired by this transfer the \$90,000,000 resources (net after deduction of treasury bonds and stocks and sinking funds)<sup>321</sup> of Portland Electric Power Company, and expanded its own consolidated resources to approximately \$364,000,000 by the end of 1930.<sup>322</sup> Moreover, the acquisition of Portland Electric Power Company permitted the financing by the Central Public Service Company system of the prior acquisition by the system of Seattle Lighting Company. On October 10, 1929, Central Public Service Corporation had contracted to purchase control of Seattle Lighting Company<sup>323</sup> from Rufus C. Dawes, Henry M. Dawes, and others, on a deferred-payment basis.<sup>324</sup> Upon transfer to Central Public Service Corporation of Portland Electric Power Company, the name of the electric company was changed to Pacific Northwest Public Service Company, and a \$16,000,000 bond issue of Pacific Northwest was sold to the public.<sup>325</sup>

Part of the proceeds of the bond issue was utilized to buy the Seattle Lighting Company from Federated Utilities, Inc., one of the com-

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light and power to 404 communities in the United States (principally in Georgia, Florida, Indiana, Illinois, Maine, Michigan, and, after 1930, in Oregon as well), Dominion of Canada, Philippine Islands, West Indies, Canary Island, and the island of Mallorca. (Id., at 432.)

<sup>317</sup> *Op. cit. supra*, note 1, at 25616-7, and Commission's Exhibits Nos. X3424 (p. 12), X4103-X4107.

<sup>318</sup> *Id.*, at 25549.

<sup>319</sup> See note 33, *supra*.

<sup>320</sup> See Table 3, *supra*, p. 506.

<sup>321</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. X4114 (Annex A).

<sup>322</sup> *Op. cit. supra*, note 316, at 745.

<sup>323</sup> *Id.*, at 857-8.

<sup>324</sup> *Op. cit. supra*, note 1, at 25554.

<sup>325</sup> *Id.*, at 25554 et seq. and Commission's Exhibit No. X4114.

panies in the Central Public Service System, which in turn used part of the funds to liquidate the liabilities incurred in connection with its purchase of Seattle Lighting Company from Rufus C. Dawes, Henry M. Dawes, and other original owners of the company.<sup>326</sup>

The expansion of the Central Public Service Company was consistent with the purposes of Harris Forbes & Company. According to Mr. Burroughs, Harris, Forbes & Company was interested in helping the Central Public Service Company System to grow:<sup>327</sup>

Q. Of course, Harris Forbes was interested in watching it grow?

A. Interested in helping it grow.

Q. They were in the business of financing purchases, and also refunding issues, that were already outstanding?

A. They were interested in buying all securities that the company had to sell which it considered were desirable investments for its clients: yes, sir. We wanted as large a volume of business as we could get: we were in business to do business and were glad to get business.

Although the selling circulars used in connection with the original distribution of the General Investment Corporation's issues to the public contained no reference to that type of contemplated activity, the management of General Investment Corporation considered the activity of transferring utility properties to utility systems in exchange for substantial common stock in such systems as one of the functions of the investment company.<sup>328</sup>

However, Mr. Burroughs testified that the acquisition by Central Public Service Corporation of Seattle Lighting Company and the other properties in the light of hindsight had been made at an excessive cost, with a consequent danger to the financial stability of the Central Public Service Company system from overexpansion. As a consequence, the financial condition of General Investment Corpora-

<sup>326</sup> Ibid.

<sup>327</sup> Id., at 25549.

<sup>328</sup> The original prospectuses stated only that the company had been formed "to buy, sell, and/or hold common stocks and/or other securities," and that it "will be the present policy of the Directorate to limit the investments of the Corporation to minority and/or controlling interests in securities of public utility companies, both foreign and domestic". (Id., Commission's Exhibit No. X3978.)

On December 14, 1929, after 1,274,194 shares of the company's common stock had been distributed to approximately 20,000 shareholders (other than the sponsors) (id., Commission's Exhibit No. X3978) at a cost to them of \$36,847,389.03 (see Table 3), a circular signed by Frederick S. Burroughs, the president of the corporation, was issued, which stated: "\* \* \* the corporation is considered by many to be an investment trust. Definitely this is not the case, for unlike an investment trust which confines itself to investing a relatively small part of its capital in each of a highly diversified list of securities, it is the policy of Public Utility Holding Corporation to acquire relatively large interests in a comparatively few enterprises. In some cases control is acquired, while in other cases, the objective is simply a large minority interest \* \* \*. Control of utility companies will be acquired only in such cases as our management sees an opportunity (1) to revamp the capital structure so as to increase the earning power of the equity stock and therefore its value, whereupon it will be turned over to one of the group companies in which we already have an important interest, in exchange for such an interest, or (2) to finance during a development period sound enterprises which cannot be advantageously financed in their own name during the development period". (Id., Commission's Exhibit No. X3978.)

However, even this circular did not indicate that the investment policies of General Investment Corporation might be directed toward utility systems which Harris, Forbes & Company served as bankers and might result in increasing the banking opportunities of Harris, Forbes & Company. (Ibid.)

tion, which had a substantial investment in the equity securities of Central Public Service Company and of Central Public Service Corporation, had been also endangered.<sup>329</sup>

Q. This relationship and this activity in connection with these two acquisitions of Central Public Service, and the relationship existing between Central Public Service, P. U. H. [General Investment Corporation], and Harris Forbes, was one in which a company which was managed by Harris Forbes was putting up junior money which provided the basis for senior financing, which was used to buy more properties for the Central Public Service System, for which Harris Forbes was the banker?

A. I think that is correct.

Q. And the relationship, of course, was not too healthy a relationship for Public Utility Holding Corporation.

A. We thought it was a very good one.

Q. Let me put it this way: in the hands of bankers who were anxious to make a lot of money and were not so careful how they made it, such relationship would not be healthy for a company situated like Public Utility Holding Corporation?

A. No; I suppose under those circumstances it would not be. There is one thing you are overlooking, and that is one thing the Public Utility Holding, which was not only Harris Forbes but the Founders, was very anxious to acquire the interest in the voting stock of Central Public Service. Colonel Pierce would not have sold, was unwilling to sell, any of that stock to outsiders. He would only have sold it to an interest that was closely identified with the group that he was working with.

\* \* \* \* \*

Q. It might be dangerous if the bankers were overly optimistic as to the values going into a company situated as Central Public Service was.

A. We thought we were safeguarding against the danger of overoptimism on the part of anyone by having a very practical operator in Central Public Service who had no interest in the banking profit, by having the United Founders Group active in P. U. H., and they certainly had no interest in Harris Forbes making a profit. So we thought we had protected against overoptimism of any branch of the organization. We did our best to safeguard it.

Q. \* \* \* you mention New York and Richmond Companies that were taken in at a figure that proved to be very much in excess of what they were worth \* \* \*.

A. In the light of hindsight, I think Central Public Service paid Dawes far too much for the group of properties they bought from him. I don't think there can be any question about that. Central Public Service bought Seattle Lighting, Central Indiana (or some such name), and New York and Richmond—I don't remember exactly what the price was, but it included some rather long-term obligations at quite a low rate of interest, and I think the rate of interest was extremely low in the first year and then maybe stepped up—I don't remember the details, but in the light of hindsight there is no question that the Dawes purchase was the most foolish thing that Central Public Service ever did; in

<sup>329</sup> Id., at 25555-9. Mr. Burroughs testified that although Harris, Forbes & Company (the bankers of the Central Public Service Corporation) were represented on the board of directors they "had very little interest in Central Public Service" and that although he was informed in advance of the contemplated purchase from Dawes, he "was not even at the meeting" of the board of directors which passed on the purchase by the utility system, and did not "realize the excessive price that had been paid" for perhaps a year after. (Id., at 25559-61.)

fact, I would say that if it had not been for the Dawes purchase Central Public Service would never have gone on the rocks. I think that is the one transaction that wrecked Central Public Service.

\* \* \* \* \*

Q. So Central Public Service was optimistic in its expansion program?

A. No doubt about that. They made a mistake. It was a bad mistake and they suffered for it. In fact, it wrecked them.

The acquisition of the major investment of \$13,950,000 of stock of the Central Public Service Company system in exchange for Portland Electric Power Company was arranged on behalf of General Investment Corporation by George Wood and Frederick S. Burroughs of Harris Forbes & Company and George Devendorf, vice president of General Investment Corporation and on behalf of Central Public Service Corporation by Albert E. Pierce.<sup>330</sup> Frederick S. Burroughs, president of General Investment Corporation, also was a director of Central Public Service Corporation.<sup>331</sup> At the time the majority of the members of the executive committee<sup>332</sup> as well as of the board of directors of General Investment Corporation were identified with Harris, Forbes & Company.<sup>333</sup>

Both Harris, Forbes & Company and Colonel Pierce had a direct pecuniary interest in the transaction. With respect to Harris, Forbes & Company it was arranged, collateral to the exchange agreement, that that banking firm would head an underwriting syndicate to distribute \$16,000,000 bonds of Portland Electric Power Company,<sup>334</sup> the proceeds of which as previously indicated,<sup>335</sup> were to be used in part to expand the Portland Electric Power Company to include Seattle Lighting Company. In addition to this direct banking business which Harris, Forbes & Company obtained, the common stock capital of the Central Public Service Corporation was increased by about \$11,000,000 by the corporation's issuance of new stock in the exchange for the Portland Company, and consequently an additional "cushion" of assets was provided for the bonds of that corporation marketed by Harris, Forbes & Company.<sup>336</sup> Mr. Burroughs, when examined on the possible dilution of the common stock of Central Public Service Corporation by excessive payments for the properties acquired, testified:<sup>337</sup>

Q. \* \* \* Supposing there was a property worth \$11,000,000 and Central Public Service paid \$14,000,000 for it, but paid for it with the stock of Central Public Service Company, common stock, now that wouldn't hurt the bond structure of Central Public Service, would it?

A. That's right.

Q. As a matter of fact, it would improve the bond structure of Central Public Service, although it would dilute and hurt the junior equities of the Central Public Service System.

<sup>330</sup> Id., at 25540.

<sup>331</sup> Id., at 25542.

<sup>332</sup> Id., Commission's Exhibit No. X3424 at 16.

<sup>333</sup> Id., Commission's Exhibit No. X3423-6-a.

<sup>334</sup> Id., Commission's Exhibit No. X4144.

<sup>335</sup> See *supra*, p. 551.

<sup>336</sup> Op. cit. *supra*, note 1. at 25550-1.

<sup>337</sup> Id., at 25551-2.



A. If they paid more than the stock was worth, sure it would dilute it, but I don't suppose a Board of Directors would pay more than they believed the property was worth.

Mr. Burroughs testified that it was difficult in such transactions for the investment bankers to render an impartial judgment with respect to their transactions with investment companies with which the bankers were associated:<sup>338</sup>

Q. Could you formulate for us, Mr. Burroughs, the reason why you don't think it is a good idea for investment bankers to be tied up to investment trusts?

A. I think it is too difficult for any human being to be sure that he is protecting both classes of investors. I think he may be perfectly honest in his effort to be sure that he is dealing fairly with the investment trust, but I don't think it is possible for him to do it, and I think it is a bad idea for the investment bankers to have an investment trust affiliate.

Q. And in more general terms, the same thing would apply to any management who was in a position of having two companies and controlling both, and having them transact security sales back and forth?

A. It is always difficult to be sure that your transactions five years hence will look as good as they do at the time you make them. And it is just too hard. I think it is wrong. I don't think it is possible for people to maintain their balance and keep the two entirely separate. I think that is the way it is worked out. I don't think that most of the bad experience which has happened to all this class of situations was because of any dishonesty of intent, but I think it was impossible for the investment bankers that formed these investment trusts to use the same kind of judgment that they would have used if they had been only interested in investment trusts. I don't think there is any doubt about that.

Whether or not the difficulty of acting impartially in view of the existing conflict of interests between Harris Forbes & Company, banker for Central Public Service System, and Harris Forbes & Company, sponsor of General Investment Corporation, contributed to the situation, the fact remains that the exchange of Portland Electric Power Company was made in part for the Class A common stock of Central Public Service Corporation on the basis of a current artificial market price of that stock.<sup>339</sup> As heretofore indicated,<sup>340</sup> the principal single acquisition of General Investment Corporation at this time was 300,000 shares of Central Public Service Corporation Class A common stock valued at \$9,750,000. However, to the knowledge of The Harris Forbes Corporation, this aggregate market price of \$9,750,000 for these shares was largely the result of the extensive market activities in the stock by Central Public Service Company, Albert E. Pierce & Company, and Southern Gas Securities Company, a subsidiary of Central Public Service Corporation. The market activities involved purchasing the stock on the exchange and redistributing the stock through dealers off the exchange. A. E. Pierce, whose company, Albert E. Pierce & Company, had been the distributor of Central Public Service Corporation Class A stock for some time prior to 1929, testified:<sup>341</sup>

<sup>338</sup> Id., at 25586 et seq.

<sup>339</sup> Id., at 25543.

<sup>340</sup> See note 333, supra.

<sup>341</sup> Op. cit. supra, note 1, at 25617-19.



Q. What was the nature of the business of Albert E. Pierce and Company?

A. The securities business.

Q. And they were the distributors of the equity (securities) in the Central Public Service System?

A. They were the leaders of the distributors and they headed the group.

Q. They were the primary distributors of the Class "A" stock of the Central Public Service Corporation?

A. And they distributed more than any other banking house, yes.

\* \* \* \* \*

Q. They had been a distributor of Central Public Service Class A from 1924 on?

A. I don't think that it went back that far. I don't remember when the Southern System Company was purchased and that company, by a change of name, became Central Public Service Corporation, and the Class A stock outstanding had been sold by Hamilton & Company of Baltimore and from then on Albert E. Pierce and Company was the distributor and headed the syndicate.

Q. And made the market, the stock from time to time, would bid the market if it showed weakness and would distribute when the market was strong, and generally handled the distribution and policed the market?

A. That is right.

\* \* \* \* \*

Q. And the technique of servicing the market was for you to buy on the exchange and distribute out through dealers the stock that was acquired?

A. Whatever the technique that was used in those days, we used no doubt.

From February 1929 until the end of 1929, the marketing operations by Albert E. Pierce & Company involved the purchase by that firm of Class A common stock of Central Public Service Corporation which stock was resold to the issuing company at cost and which was to be subsequently remarketed by Albert E. Pierce & Company.<sup>342</sup> Between August and December 31, 1929, Albert E. Pierce & Company resold to Southern Gas Securities Company, a subsidiary of Central Public Service Corporation, at the average cost price to Albert E. Pierce & Company of \$54.28 per share, a total of 452,987 shares Central Public Service Corporation Class A stock, part of which Albert E. Pierce & Company apparently had purchased on the New York Curb Exchange and the Chicago Stock Exchange in support of the market.<sup>343</sup> These purchases were equal to about 70% of the aggregate 646,591 shares traded on both exchanges during the period stated.

During all of 1929 The Harris Forbes Corporation headed the syndicate distributing the newly issued shares of Central Public Service Corporation class A common stock.<sup>344</sup> The record contains no definite evidence that The Harris Forbes Corporation was aware of the extent of this trading by Albert E. Pierce & Company and Southern Gas Securities Company when The Harris Forbes Corporation sold to General Investment Corporation (The Harris Forbes Corporation's) entire holdings of the stock<sup>345</sup> and permitted General Investment Corporation to buy an additional 20,000 shares

<sup>342</sup> Op. cit. supra, note 316, Vol. 52, at 918-9.

<sup>343</sup> Id., at 292.

<sup>344</sup> Id., at p. 918 et seq.

<sup>345</sup> Op. cit. supra, note 1, at 25447-8, and Commission's Exhibit No. N3969.

from Albert E. Pierce & Company for \$1,100,000<sup>346</sup> in September 1929. But before January 1930 and prior to the exchange by General Investment Corporation of its holdings in Portland Electric Power Company for Class A and common shares of Central Public Service Corporation and Central Public Service Company, the Harris Forbes organization was fully advised of the nature of the market in the Central Public Service Corporation Class A stock. On December 30, 1929, the board of directors of Central Public Service Corporation, of which Frederick S. Burroughs, president of General Investment Corporation, was a member,<sup>347</sup> adopted a resolution approving the absorbing of \$9,690,368.13 of losses theretofore and thereafter to be sustained by Southern Gas Securities Corporation in its operations in maintaining the Class A common stock of Central Public Service Corporation "at a higher figure" and in "stabilizing the price of said stock in times of temporary depression."<sup>348</sup> The effectiveness of these market operations in the stock is indicated by the fact that from October 29, 1929, to December 3, 1929, following the general severe security market decline, the market price on the New York Curb Exchange of the Central Public Service Corporation Class A stock advanced from a low in October of \$20 to a high in December of \$33½ per share, or approximately 65%.

The additional \$4,200,000 investment in Central Public Service Company common stock resulting from the Portland Electric Power Company exchange, added to the \$741,996 investment in that stock acquired from its sponsors, principally The Harris Forbes Corporation itself,<sup>349</sup> and miscellaneous purchases costing \$145,848,<sup>350</sup> increased to \$5,087,824.00<sup>351</sup> an investment in a stock which had at no time (including the years 1928 and 1929) received dividend distributions.<sup>352</sup>

This \$4,200,000 investment made in this common stock at this time involved what was in substance a collateral transaction in which Albert E. Pierce apparently received at the expense of General Investment Corporation and Central Public Service Corporation a profit of about \$2,600,000 in an exchange of Central Public Service Company common stock for Central Public Service Corporation Class A common stock. In payment for the stock of Portland Electric Power Company owned by General Investment Corporation, Central Public Service Corporation issued 465,000 shares of its Class A common stock, which Central Public Service Corporation valued at \$30 a share or a total of \$13,950,000.<sup>353</sup> Of these shares, 300,000 shares went directly to General Investment Corporation, which valued them at \$32.50 a share for a total of \$9,750,000, or a mark-up of \$2.50 per share.<sup>354</sup> The remaining 165,000 shares went to personal holding companies of

<sup>346</sup> *Ibid.*

<sup>347</sup> *Id.*, at 25542 and 25560.

<sup>348</sup> *Op. cit. supra*, note 316, Vol. 52, at 928-9.

<sup>349</sup> See note 33, *supra*.

<sup>350</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. X3969. Subsequently a substantial purchase of 5,000 shares was made for \$449,800 from H. M. Byllesby & Co. (*Ibid.*) H. M. Byllesby & Co. was one of the principal bankers for the Central Service Company system. (*Op. cit. supra*, note 316, Vol. 52, p. 918 et seq.)

<sup>351</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. X3969.

<sup>352</sup> *Op. cit. supra*, note 316, Vol. 52, p. 1070.

<sup>353</sup> Federal Trade Commission, *op. cit.*, Vol. 52, p. 924.

<sup>354</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. X4101.

Albert E. Pierce,<sup>355</sup> which in turn transferred to General Investment Corporation 175,000 shares of the common stock of Central Public Service Company. These common shares, which General Investment Corporation valued on its books at \$24 per share for a total of \$4,200,000, were, in substance, transferred to General Investment Corporation in lieu of the 165,000 shares of Class A stock of Central Public Service Corporation. The apparent profit realized by Pierce on this substitution of common shares of Central Public Service Company for the Class A shares of Central Public Service Corporation may be computed on several bases. On the basis of the \$30 per share valuation given its Class A stock by Central Public Service Corporation, Pierce received 165,000 of this Class A stock, having a value of \$4,950,000, in exchange for the Central Public Service Company common stock valued by General Investment Corporation at \$4,200,000, or a profit of \$750,000. On the basis of the \$32.50 valuation placed on the Class A stock of Central Public Service Corporation by General Investment Corporation, Colonel Pierce received 165,000 shares of such Class A with a value of \$5,362,500 in exchange for 175,000 shares of Central Public Service Company common stock valued by General Investment Corporation at \$4,200,000, a profit of \$1,162,000.

On the basis of market prices, at January 31, 1930, the date of the exchange contract, Colonel Pierce received 165,000 shares of the Class A stock having a current market value of \$5,857,500 in exchange for 175,000 shares of the common stock (35,000 shares before the current split-up of 5 for 1,<sup>356</sup> having a current market value of \$3,255,000, or an excess value in terms of current market prices amounting to \$2,602,500.<sup>357</sup>

Colonel Pierce, however, denied that he in fact derived any pecuniary advantage by the exchange of the common stock for the Class A stock and stated that the apparent advantage to him may have been the result of "bookkeeping" on the part of General Investment Corporation:<sup>358</sup>

Q. \* \* \* Now, at that rate there is a discrepancy of \$1,162,500 between the Class A stock, 165,000 shares, and the common stock, 175,000 shares, involved in this exchange with Somers?

A. No; that had nothing to do with me.

Q. That has nothing to do with you?

A. I am not concerned with that.

\* \* \* \* \*

Q. But from that it is apparent that there is a discrepancy of \$1,162,000?

A. I should think that P. U. H. would have to explain where that went to, but I had nothing to do with it. I mean if they [Central Public Service] bought one class of stock and paid a great deal more for it than the others maybe Mr. Somers made that profit.

Q. But if the Class A stock was worth what it was taken on the books of P. U. H. for and the common stock was worth what it was taken on the books of P. U. H. for, then you did get—

<sup>355</sup> Id., at 25543, 25621. The exchange was made by Pierce Investment Company, the personal holding company of Colonel A. E. Pierce through the medium of United Shareholders, Inc., and Elbert H. Somers, Jr., an intermediary injected to avoid taxes. (Ibid.)

<sup>356</sup> Id., Commission's Exhibit No. X4101.

<sup>357</sup> The Class A stock had a current market value of \$35½ per share and the common stock (before the 5 for 1 split-up) had a current market value of \$93 per share.

<sup>358</sup> Id., at 25626-8.

A. Not me; I did not get that. That is the deal made with Mr. Somers. Mr. Somers and I made a deal whereby I exchanged 165,000 shares for 175,000 shares and that was all there was to it.

\* \* \* \* \*

Q. I merely pointed out that you received an amount of \$750,000 which I now see is \$1,162,000 in excess values in terms of these contracts?

A. As I see that it is a matter of P. U. H. bookkeeping, and it may be lousy bookkeeping, but it doesn't state the facts.<sup>359</sup>

The participation of Colonel Pierce, the sponsor of Central Public Service Corporation, as a contracting party in the transactions involving the transfer of Portland Electric Power Company to Central Public Service Corporation and the apparent profit which he derived in this transaction at the expense of General Investment Corporation or Central Public Service Corporation caused no concern to the management of General Investment Corporation. The management manifested no interest, despite the fact that as a result of the transaction General Investment Corporation became one of the two largest stockholders of both Central Public Service Company and Central Public Service Corporation.<sup>360</sup> Frederick S. Burroughs, the president of General Investment Corporation, testified: <sup>361</sup>

Q. Was there any concern—did it occasion any concern on your part that as part of this transaction Colonel Pierce received stock of Central Public Service Corporation which had just been issued for \$4,950,000 in exchange for stock of Central Public Service Company which was sold to P. U. H. [General Investment Corporation] for \$4,200,000, leaving a difference of \$750,000?

A. No; it wasn't any concern on my part.

As has been indicated, General Investment Corporation recorded upon its books a profit of \$2,136,060.64, which it reported as income for tax purposes, on its exchange of the common stock of Portland Electric Power Company costing \$11,813,939.36 for the stocks of Central Public Service Company and Central Public Service Corporation.<sup>362</sup> This profit was arbitrarily recorded as the result of valuing the 175,000 shares of Central Public Service Company common stock at \$4,200,000 and the 500,000 shares of Central Public Service Corporation Class A shares at \$9,750,000, or a total of \$13,950,000.<sup>363</sup> Moreover, as previously pointed out,<sup>364</sup> the market value of the Central Public Service Corporation Class A stock was at the time, to the knowledge of the president of General Investment Corpo-

<sup>359</sup> Had General Investment Corporation carried the 300,000 shares of Central Public Service Corporation Class A stock at the issue price of \$30 per share, or a total of \$9,000,000, and the Central Public Service Company common stock at \$28.30 per share for a total of \$4,950,000, then the apparent discrepancy, in favor of Colonel Pierce in the exchange appearing on the books of General Investment Corporation or of Central Public Service Corporation, would have been eliminated.

<sup>360</sup> *Op. cit. supra*, note 1, at 25548. As at May 31, 1930, General Investment Corporation held 297,600 shares, or in excess of 25% of the common stock of Central Public Service Corporation and 339,401 shares of the Class A common stock of Central Public Service Corporation, or approximately 20% of such stock outstanding. (*Id.*, Commission's Exhibit No. X3423 [Exhibit 5a, p. 9].)

<sup>361</sup> *Id.*, at 25544.

<sup>362</sup> *Id.*, at 25543.

<sup>363</sup> As previously indicated, these valuations bore no relationship either to the issue price of the stock or to its current market price.

<sup>364</sup> See note 348, *supra*.

ration, largely influenced by the large purchases of Albert E. Pierce & Company on the exchange and by the distribution off the exchange. In this respect, George Devendorf, who was at the time a vice president of the investment company, testified that both the \$2,136,060.64 profit and the \$13,950,000 valuation of securities received in the Portland Electric Power Company exchange were "arbitrary," and inflated not only the assets but more significantly, the income report of the investment company:<sup>365</sup>

A. Those were arbitrary values that were assigned to it for the purpose of our bookkeeping and on what they were based and what reference those had to intrinsic value I couldn't tell you now. I would have known at the time.

Q. Was it customary for the Board of Directors of P. U. H. [General Investment Corporation] to carry on to their books securities which had a value of less than the value ascribed or to carry on the value in excess of its real value?

A. That would be a practice, but when you have an involved trade that takes in two or three different kinds of stock and cash, you arbitrarily assign different values to the different things, and you wouldn't assign something that was really wrong, but you might change one value, and make one value less and another value more and now why those were made that particular value I haven't any idea.

Q. But on the basis of valuations that you have adopted in this contract, that P. U. H. adopted in this contract here, there was either an inflation of \$1,100,000 or Colonel Pierce got something.

A. Well, I was sure at the time and I am still sure today that Colonel Pierce didn't get anything. And now while the figures show this discrepancy, I can't say.

Q. Well, of course, on the basis of valuation that you adopt here you show a profit of two million dollars in your income statement?

A. Yes.

Q. So that you were inflating your income statement which is more serious than just inflating your assets; that is correct, isn't it?

A. That is right, to the extent that they were overvalued. We would be inflating our income for that year.

During 1930, an additional large block of the common stock of Central Public Service Company was acquired by General Investment Corporation primarily through its participation in a trading account with Albert E. Pierce & Company. On February 19, 1930, the common stockholders of Central Public Service Company voted to "split up" its common stock by issuing 5 new shares in exchange for each outstanding share of its common stock.<sup>366</sup> Prior to this split-up, General Investment Corporation, on February 14, 1930, purchased from Equity Ownership Corporation<sup>367</sup> through A. E. Pierce & Company 50 000 shares of the new common stock of Central Public Service Company (after the split-up) for \$1,000,000 on the understanding that Albert E. Pierce & Company would remarket this stock to the public, receiving as compensation one-half of the profits made by

<sup>365</sup> Op. cit. supra, note 1, at 25649-51.

<sup>366</sup> *Poor's Manual of Public Utilities*, 1930, p. 939. The effect of the split-up was to increase the outstanding common stock from 213,846 shares to 1,069,230 shares. (Ibid.)

<sup>367</sup> Messrs. Pierce and Burroughs testified that they were unable to identify this corporation or its beneficial owners.

General Investment Corporation on the redistribution. The agreement further provided that General Investment Corporation at its option was to have the right to require Albert E. Pierce & Company to purchase one-half of the shares remaining in the account at its termination.<sup>368</sup> The agreement between the parties also contemplated that the stock would be traded in on the New York Curb Exchange and the Chicago Stock Exchange in connection with this redistribution.<sup>369</sup>

Between February 25 and June 14, 1930, General Investment Corporation through this account with Albert E. Pierce & Company purchased in addition to the original 50,000 shares of common stock of Central Public Service Company acquired through Albert E. Pierce & Company, a total of 43,321 shares on the Chicago Stock Exchange and New York Curb Exchange,<sup>370</sup> constituting 57% of the total 76,000 shares traded on both exchanges.<sup>371</sup> During the same period through this account, Albert E. Pierce & Company on behalf of General Investment Corporation disposed of 37,693 shares, of which only 9,790 shares were sold on the New York Curb Exchange and Chicago Stock Exchange.<sup>372</sup> The market price of the stock rose from approximately \$25 a share to \$35 a share over the period of the operation of this trading account.

On June 14, 1930, the account was terminated with an unsold balance of 55,718 shares which had cost the parties \$1,406,436.<sup>373</sup> General Investment Corporation exercised its option requiring Albert E. Pierce & Company to take one-half of the undistributed balance and accordingly retained 27,859 of these shares at a cost of \$703,218.40 as its proportionate share in the account.<sup>374</sup>

As heretofore indicated, the Portland Electric Power Company exchange resulted in the recording of arbitrary income items in the financial reports for the period ending May 31, 1930. The result of the trading account in Central Public Service Company common stock, apart from adding an excess cost of about \$146,000 to the investment in this common stock<sup>375</sup> was to permit in addition the management of

<sup>368</sup> Op. cit. supra, note 1, Commission's Exhibit No. X4120.

<sup>369</sup> Ibid. On February 21, 1930, George Woods, the treasurer of General Investment Corporation, wrote to A. E. Pierce & Company: "It is our expectation that in connection with the distribution of the new common stock it will be traded in on the New York Curb market as well as on the Chicago Stock Exchange."

<sup>370</sup> Ibid. The volume purchased by Albert E. Pierce & Company for this account on the New York Curb Exchange was 27,900 shares and on the Chicago Stock Exchange, 15,421 shares.

<sup>371</sup> The trading in this account in Central Public Service Company's common stock from February 25 to June 14, 1930, as compared with the recorded volume of trading for the same period in such stock on the New York Curb Exchange and Chicago Stock Exchange as published in the *Commercial & Financial Chronicle* was as follows: Purchases by account on New York Curb, 27,900; volume of trading on New York Curb, 47,000; percent of account purchases to total volume, 59%. Purchases by account on Chicago Stock Exchange, 15,421; volume of trading on Chicago Stock Exchange, 29,000; percent of account purchases to total volume, 53%.

<sup>372</sup> Op. cit. supra, note 1, Commission's Exhibit No. X4120.

<sup>373</sup> Ibid.

<sup>374</sup> Id., Commission's Exhibit No. X4120.

<sup>375</sup> Inasmuch as the original cost to General Investment Corporation of the shares in this account was \$20 per share or \$557,180 for 27,859 shares, of the \$703,218 cost of the 27,859 share balance acquired, about \$146,000 represented an excess cost resulting from the trading.

General Investment Corporation to mislead the shareholders thereof with respect to the value of the assets of the investment company. General Investment Corporation held approximately 297,600 shares of Central Public Service Company common stock at a cost of \$6,287,026.26<sup>376</sup> and 339,401 shares of the Class A stock of Central Public Service Corporation at a cost of \$11,345,947 largely as a result of the purchase from sponsors, the exchange for Portland Electric Power Company and the trading account managed by Albert E. Pierce & Company by May 31, 1930.<sup>377</sup> As at May 31, 1930, these holdings constituted approximately one-third of General Investment Corporation's total portfolio valued at cost.<sup>378</sup> The then market value of the 297,600 shares of Central Public Service Company stock held by General Investment Corporation at a cost of \$6,287,026.26 was \$40 per share or a total market value of approximately \$11,904,000. This market value necessarily reflected the trading by Albert E. Pierce & Company in the Central Public Service Company common stock for the account of General Investment Corporation itself.<sup>379</sup> Nevertheless, the letter of F. S. Burroughs, the president of General Investment Corporation, to its stockholders as of May 31, 1930, without referring to this trading account, stated:<sup>380</sup>

While quoted markets do not necessarily reflect the value of concentrated holdings of securities such as are held by your Corporation, Messrs. Haskins & Sells in their audit as of May 31, 1930, state: "The value of marketable securities at market quotations, as of the end of May, was in excess of book value, which represents cost."

The total difference between the market value and the cost of the marketable securities held by the General Investment Corporation as at May 31, 1930, was approximately \$1,767,882<sup>381</sup> and the only basis for this excess "value" based on market quotations was the unrealized appreciation in the investment company's holdings of the common stock of Central Public Service Company,<sup>382</sup> in which stock a trading account had been operated by Albert E. Pierce & Company for the account of the investment company.

The result of the relationship among General Investment Corporation, the Central Public Service Company system and Harris, Forbes

<sup>376</sup> Op. cit. supra, note 1, Commission's Exhibits Nos. X3969, X3423, A-A7.

<sup>377</sup> Id., Commission's Exhibit No. X3423-B at p. 3.

<sup>378</sup> The portfolio of securities held by General Investment Corporation at this date were acquired at a total cost of approximately \$52,800,000. (Id., Commission's Exhibit No. X3423-5a.)

<sup>379</sup> As heretofore indicated, between March and June 1930, General Investment Corporation purchased about 54% of the total number of shares of this stock traded on both the New York Curb Exchange and the Chicago Stock Exchange at an average price of \$35 per share. (Id., Commission's Exhibit No. X4120.)

<sup>380</sup> Id., Commission's Exhibit No. X3423 (5a) at p. 11.

<sup>381</sup> Id., Commission's Exhibit No. X3423-A at p. 22.

<sup>382</sup> As at May 31, 1930, exclusive of the Central Public Service Company common stock, General Investment Corporation held marketable securities with a cost of \$43,472,666 and a current market value of \$39,632,935, or approximately \$4,000,000 less than cost. (Id., Commission's Exhibit No. X3423-B, Table 2.) Including the Central Public Service Company common stock, General Investment Corporation held a portfolio of marketable securities costing \$49,759,692 which had a market value in excess of cost by \$1,767,882. (Id., Commission's Exhibit No. X3423-A at pp. 1, 2.)



& Company had been to increase constantly, with one exception,<sup>383</sup> the investment of General Investment Corporation in the Central Public Service system. Finally the necessity for reorganizing the Central Public Service Company System became apparent in the latter part of 1931;<sup>384</sup> and the Chase Securities Corporation (at that time the security affiliate of the Chase National Bank of New York, which in 1930 had acquired control of Harris Forbes Companies<sup>385</sup>) insisted that General Investment Corporation take over control of Central Public Service Company system in order to work out this reorganization.<sup>386</sup> Accordingly, on December 31, 1931, General Investment Corporation exchanged 132,672 shares of Central West Public Service Company common stock, costing about \$1,558,187.26,<sup>387</sup> with Pierce Investment Company, the personal holding company of Colonel A. E. Pierce, for 199,846 shares of Central Public Service Company common stock. This increased the investment of General Investment Corporation in Central Public Service Company common stock to 509,673 shares, recorded<sup>388</sup> at a cost of \$8,097,644.35.<sup>389</sup> This particular exchange apparently gave no advantage to Pierce Investment Company since Central West Public Service Company thereafter "went into bankruptcy."<sup>390</sup>

The total block of 509,673 shares of Central Public Service Company common stock held by General Investment Corporation constituted slightly less than 50% of the 1,069,230 shares of such stock then outstanding.<sup>391</sup> To assure indisputable control by General Investment Corporation of Central Public Service Company, a voting trust was created, with Colonel Pierce and Messrs. Devendorf and

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<sup>383</sup> In March 1931 General Investment Corporation exchanged with Albert E. Pierce & Company 118,418 shares Central Public Service Corporation Class A stock valued at \$3,667,765.10 for stock of American Commonwealths Power Corporation valued at \$2,894,604.30 and its own common stock and warrants valued at \$773,160.80. This increased General Investment Corporation's earlier investment of \$1,059,449.48 in American Commonwealths Power Corporation, acquired principally from the A. E. Pierce interests, to almost \$4,000,000. (Id., at 25573 and Commission's Exhibit No. X3969.) Almost immediately after this major acquisition by General Investment Corporation in March 1931, American Commonwealths Power Corporation went into receivership. (Id., at 25574-5.) This \$4,000,000 investment was resold by General Investment Corporation, principally during 1934 and 1935, at a loss of \$3,706,000. (Id., Commission's Exhibit No. X3969.)

<sup>384</sup> Id., at 25631.

<sup>385</sup> See note 3, *supra*.

<sup>386</sup> Op. cit. *supra*, note 1, at 25614, 25615.

<sup>387</sup> Id., Commission's Exhibit No. X3969. Control of Central West Public Service Company resulted from loans theretofore made to Porter Fox & Company, the sponsor of Central West Public Service Company. (Id., at 25566-7 and Commission's Exhibit No. X4122.)

<sup>388</sup> While General Investment Corporation increased its investment in Central Public Service Company, the market value of the 200,846 shares acquired was only \$7 per share, or a total of \$1,405,922. Inasmuch as Central West Public Service Company went into receivership shortly thereafter, the books of General Investment Corporation preserved as part of the cost of the investment in Central Public Service Company an unrecorded loss of approximately \$152,000 (the difference between the cost of Central West Public Service Company and the market value of the Central Public Service Company stock received in exchange therefor), realized on the disposition of the investment in Central West Public Service Company.

<sup>389</sup> Op. cit. *supra*, note 1, Commission's Exhibit No. X3969.

<sup>390</sup> Id., at 25632.

<sup>391</sup> Op. cit. *supra*, note 316, Vol. 52, at 1025.



Woods as trustees,<sup>392</sup> covering 193,518 Central Public Service Company common shares deposited by Colonel Pierce and 509,673 common shares deposited by General Investment Corporation.<sup>393</sup>

On August 1, 1932, a plan of reorganization of the Central Public Service Corporation was proposed to its security holders.<sup>394</sup> At this time, General Investment Corporation held 249,467 shares of Central Public Service Corporation Class A stock costing \$7,697,642.53, and 509,673 Central Public Service Company common stock voting trust certificates costing \$8,097,624.35.<sup>395</sup> This plan of reorganization,<sup>396</sup> which was adopted in 1934, provided for the creation of a new corporation, Central Public Utility Corporation, which issued its securities in exchange for those of Central Public Service Corporation.<sup>397</sup> And, accordingly, General Investment Corporation surrendered its 249,467 shares of Central Public Service Corporation Class A stock for the same number of shares of Central Public Utility Corporation Class A stock.<sup>398</sup> The only substantial changes effected in the capital structure of Central Public Service Corporation were to convert about \$40,000,000 of the fixed interest obligations of that corporation to an equivalent amount of income debentures of Central Public Utility Corporation; and to issue common stock of the new corporation in an amount equal to three times the number of common shares of the old corporation outstanding. The debenture holders were given two-thirds of this new common stock, while Central Public Service Company was given one-third of the common stock of the successor corporation,<sup>399</sup> or a number of new shares equal to the number of old shares held by the service company.

However, while the plan of reorganization apparently recognized the rights of the debenture holders of Central Public Service Corporation to the extent that provision was made for them to receive two-thirds of the common stock of the successor corporation, the plan effectively deprived these debenture holders of any voice in the management of the new corporation. The plan provided for the creation of an additional new corporation, Consolidated Electric and Gas Company, to which all of the assets of Central Public Service Corporation were transferred.<sup>400</sup> To this new corporation, General Investment Corporation made the sole contribution of new capital involved in the reorganization,<sup>401</sup> namely, Elektrizitaetswerke Suedwest A. G. debentures having a value of about \$1,100,000 which General Investment Corporation had purchased in 1930 at a cost of \$3,107,000.<sup>402</sup> For these Suedwest debentures, General Investment Corporation received 23,000 shares of Consolidated Electric and Gas

<sup>392</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. X3762. Messrs. Devendorf and Woods were identified with the General Investment Corporation.

<sup>393</sup> *Op. cit. supra*, note 316, Vol. 52, at 1023 et seq.

<sup>394</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. X4123.

<sup>395</sup> *Id.*, Commission's Exhibit No. X3969.

<sup>396</sup> *Id.*, at 25639.

<sup>397</sup> *Id.*, Commission's Exhibit No. X4123.

<sup>398</sup> *Id.*, Commission's Exhibit No. X3969.

<sup>399</sup> *Id.*, at 25639-42 and Commission's Exhibit Nos. X4123 and X4124.

<sup>400</sup> *Id.*, Commission's Exhibit No. X4123.

<sup>401</sup> *Id.*, at 25657.

<sup>402</sup> *Id.*, Commission's Exhibit No. X3970. These debentures were subsequently sold in 1933 for \$1,101,464.76 by Consolidated Electric and Gas Company. (*Id.*, Commission's Exhibit No. X4143 [Consolidated Electric and Gas Company Annual Report, 1933].)

Company's preferred stock and its entire issue of 1,000,000 shares of common stock. The common shares of Consolidated Electric and Gas Company so received were immediately donated under the plan to the newly formed Central Public Utility Corporation.<sup>403</sup> However, under the reorganization plan, a voting trust for the 1,000,000 shares of Consolidated Electric and Gas Company common stock was created. The three trustees under the voting trust were George Devendorf, president of General Investment Corporation, W. T. Crawford, of Stone & Webster, Inc., and Rawleigh Warner, a representative of the Dawes family, of Chicago, which was a substantial creditor of the Central Public Service Company System.<sup>404</sup> Mr. Devendorf also became chairman of the board of Consolidated Electric and Gas Company.<sup>405</sup> The management of the system was given by contract to Stone & Webster, Inc., who had formulated and sponsored the plan of reorganization.<sup>406</sup>

In substance, the reorganization placed the resources of Central Public Service Corporation in the newly formed Consolidated Electric and Gas Company and placed the common-stock interest which was tied up by the voting trust in this new company in the newly formed Central Public Utility Corporation. Although General Investment Corporation made the only contribution of additional capital in the reorganization, Central Public Service Company, which had theretofore held all of the common stock of Central Public Service Corporation, nevertheless acquired one-third of the common stock of the successor, Central Public Utility Corporation.<sup>407</sup>

In 1935 and 1936, General Investment Corporation sold for \$391,125 its investments in the Consolidated Electric and Gas Company preferred stock, Central Public Utility Corporation Class A common stock, and Central Public Service Company common stock which had cost General Investment Corporation in the aggregate \$18,902,478.59, resulting in a loss of \$18,511,353.59,<sup>408</sup> which, with the \$2,786,066.71 loss on the American Commonwealths Power Corporation stock, heretofore mentioned,<sup>409</sup> adds to an aggregate loss of \$21,395,957.89.

Of the total \$390,000 received by General Investment Corporation, \$70,000 was received from A. E. Pierce as the purchase price of the 509,673 shares of Central Public Service Company common stock and 249,467 shares Central Public Utility Corporation Class A common stock.<sup>410</sup> Thereafter, under the guidance of Mr. Devendorf, then president of General Investment Corporation,<sup>411</sup> Colonel Pierce resold these shares to American Equities Corporation (an investment company sponsored by one Percy Chandler) for a profit

<sup>403</sup> *Id.*, at 25656-7.

<sup>404</sup> *Id.*, at 25669.

<sup>405</sup> *Id.*, at 25669-70, 25675.

<sup>406</sup> *Id.*, at 25675.

<sup>407</sup> *Id.*, at 25639-42 and Commission's Exhibit No. X4123.

<sup>408</sup> *Id.*, Commission's Exhibits Nos. X3969 and X3970.

<sup>409</sup> *Ibid.* United States & Overseas Corporation had also met part of the financial requirements of the Central Public Service Company System. In addition to participation in the \$1,000,000 loan to Portland Electric Power Company previously mentioned, United States & Overseas Corporation invested \$355,379 in the Central Public Service Company System and lost \$138,793.84 thereof. (*Id.*, Commission's Exhibit No. X3962.)

<sup>410</sup> *Id.*, Commission's Exhibit No. X3969.

<sup>411</sup> *Id.*, at 25685.

of over \$100,000.<sup>412</sup> Shortly thereafter, Mr. Devendorf resigned as president of General Investment Corporation<sup>413</sup> and, as will be discussed more fully, purchased, in conjunction with American Equities Corporation, from General Investment Corporation for \$320,000,<sup>414</sup> the 23,000 preferred shares of Consolidated Electric and Gas Company which had cost General Investment Corporation about \$3,107,000 at the time of the reorganization of the utility system.

## 7. PARTICIPATION OF GENERAL INVESTMENT CORPORATION IN THE ACQUISITION OF CONTROL OF WASHINGTON GAS LIGHT COMPANY FOR THE BENEFIT OF CENTRAL PUBLIC SERVICE COMPANY—LOSS, APPROXIMATELY \$967,000

In addition to its aid in enabling Central Public Service Corporation to acquire control of Portland Electric Power Company and Seattle Lighting Company, General Investment Corporation also was caused to participate with others in acquiring control of Washington Gas Light Company for the account of the Central Public Service Company. In this activity General Investment Corporation invested a total of \$967,126.50, all of which was eventually lost. However the acquisition resulted in additional banking business for Harris Forbes & Company.

Washington Gas Light Company is a public utility company doing business in the District of Columbia and its environs.<sup>415</sup> Its capitalization early in 1929 consisted of 130,000 shares of common stock and approximately \$10,700,000 of debentures and notes.<sup>416</sup>

This utility was ostensibly protected from the influence and control of utility holding companies by a federal statute known as the "La Follette Antimerger Statute" which forbade any local or foreign holding corporation from owning or voting directly or indirectly any of the stock or bonds of any public utility company doing business in the District of Columbia.<sup>417</sup> The law, however, empowered the Public Utility Commission of the District of Columbia to prosecute for violations of the statute only when a holding corporation had acquired 20% of the capital stock of a District of Columbia utility company.<sup>418</sup> However, although the statute prohibited the direct or indirect control of a utility operating in the District of Columbia by another corporation, it did not in terms prohibit such control by an unincorporated association or a common law business trust.

Early in 1929 it had come to the attention of Harris Forbes & Company that a syndicate (in which Utilities Power & Light Corporation, a large public utility holding company, then dominated by

<sup>412</sup> Id., at 25636-8. A. E. Pierce testified that he sold the stock to Mr. Chandler. However, the purchase from Colonel Pierce appears on the books of American Equities Corporation. (Id., Commission's Exhibit No. X4146.)

<sup>413</sup> Id., at 25669.

<sup>414</sup> Id., at 25657-8 and Commission's Exhibits Nos. X3970 and X4146.

<sup>415</sup> Op. cit. supra, note 316, Vol. 52, at 365.

<sup>416</sup> *Poor's Manual of Public Utilities*, 1931, at pp. 2129-31.

<sup>417</sup> Op. cit. supra, note 316, Vol. 52, at 361.

<sup>418</sup> Ibid.

Harley C. Clarke,<sup>419</sup> was the largest participant)<sup>420</sup> was then engaged in purchasing the common stock of Washington Gas Light Company.<sup>421</sup> By April 1, 1929, Harris Forbes & Company completed negotiations by which they formed a syndicate of investment bankers and investment companies to purchase the interest of the Utilities Power & Light Corporation syndicate in Washington Gas Light Company for the account of the Central Public Service Company system. On April 1, 1929, The Harris Forbes Corporation, American Founders Corporation (one of the companies in the United Founders Corporation group), Chase Securities Corporation, H. M. Byllesby & Company and Schoellkopf, Hutton and Pomeroy, under the guidance of the Harris Forbes organization,<sup>422</sup> participated in the formation of a Massachusetts common law trust eventually known as Washington & Suburban Companies.<sup>423</sup> Each of the participants contributed \$1,000,000 or a total of \$5,000,000 to the trust which issued to each of the organizers 25,000 shares of beneficial interest or a total of 125,000 of such shares.<sup>424</sup> The formation of this trust, which subsequently acquired control of Washington Gas Light Company was apparently intended to circumvent the federal statute forbidding the acquisition of control by a corporation of District of Columbia utility companies.

In addition to the \$5,000,000 received from its organizers, Washington & Suburban Companies borrowed \$10,300,000 from various banks evidenced by its notes.<sup>425</sup> Washington & Suburban Companies acquired, for \$6,519,450, all the 43,463 shares of the common stock of Washington Gas Light Company held by the Utilities Power & Light Corporation syndicate, resulting in a profit to such syndicate of \$1,418,000.<sup>426</sup> Thereafter, largely as a result of its public offers to

<sup>419</sup> Op. cit. supra, note 316, Vol. 54, at 287. The Harley C. Clarke influence in Utilities Power & Light Corporation was removed on October 10, 1936, when he resigned as president and director. (Public Examination, Atlas Corporation, Commission's Exhibit No. 2026.) Utilities Power & Light Corporation filed a petition for the appointment of a receiver on January 4, 1937, and in August 1937 a permanent trustee in bankruptcy was appointed. (*Moody's Manual of Investments, Public Utilities*, 1938, p. 2266.)

<sup>420</sup> Public Examination, Atlas Corporation, at 25576. This syndicate was managed by Dana Pearson. The participants and the percentage of their interests in this syndicate which was formed on April 20, 1928, were Dana Pearson, 5%; Pynchon & Company, 15.95%; Utilities Power & Light Corporation, 37.85%; Chase Securities Corporation, 18.93%; Shermer Corporation (controlled by Albert Wiggin, then president of the Chase National Bank), 18.93%; and J.O'Donnell, 3½%. (Hearings before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess., on S. Res. 84, 56, and 97, Part 6, Chase Securities Corporation, pp. 2858, 2877, 3131-3135.)

<sup>421</sup> Op. cit. supra, note 1, at 25577-9.

<sup>422</sup> Id., at 25579.

<sup>423</sup> Id., at 25579 and Commission's Exhibits Nos. X4125, X4126, X4150. Until March of 1931, Washington & Suburban Companies was known as Seaboard Investment Trust. (Ibid.)

<sup>424</sup> Ibid.

<sup>425</sup> Id., at 25578-81 and Commission's Exhibit No. X4136. These bank loans were secured by the deposit as collateral by Washington & Suburban Companies of a large portion of the Washington Gas Light Company stock acquired. (Op. cit. supra, note 316, Vol. 52, at 978.)

<sup>426</sup> Hearings before the Senate Committee on Banking and Currency, 73rd Cong., 1st Sess., on S. Res. 84, 56 and 97, Part 6, at 2858. Washington & Suburban Companies paid the syndicate a premium of \$25 a share above the then market price of the Washington Gas Light Company's common stock, largely because the stock held by the syndicate would otherwise have constituted an obstacle in the way of the Central Public Service Company system's attempt to acquire control of Washington Gas Light Company. (Op. cit. supra, note 1, at 25581.)

purchase the common stock of Washington Gas Light Company at \$125 per share,<sup>427</sup> Washington & Suburban Companies increased its holdings of such stock to 109,181 shares,<sup>428</sup> or the equivalent of about 85% of such shares then outstanding.<sup>429</sup> By the end of October 1929 the aggregate cost of this total block of shares to Washington & Suburban Companies was \$14,777,000.<sup>430</sup>

On April 19, 1929, the day that its organizers acquired the stock of Washington & Suburban Companies, Central Public Service Company agreed with the organizers that on or before April 30, 1931, it would "purchase or find purchasers"<sup>431</sup> for their 125,000 shares of beneficial interest in Washington & Suburban Companies for \$6,000,000, or a profit to the organizers of \$1,000,000 on their investment of \$5,000,000. Thus, The Harris Forbes Corporation and the other organizers of Washington & Suburban Companies were essentially functioning as bankers for Central Public Service Company by supplying for the account of that company, for a two-year period, the funds necessary to acquire control of Washington Gas Light Company.

However, before the two-year period during which Central Public Service Company had to acquire (or find purchasers for) the shares of Washington & Suburban Companies from the organizers ended, the investment bankers who participated in this financing for the account of Central Public Service Company transferred substantial blocks of Washington & Suburban Companies shares to investment companies which they had sponsored or controlled.<sup>432</sup> On May 16, 1929, The Harris Forbes Corporation assigned to United States & Overseas Corporation, for \$500,500, 12,500 shares of beneficial interest in Washington & Suburban Companies, that is, one-half of The Harris Forbes Corporation's holdings of such shares.<sup>433</sup> In November 1930, the United Founders Corporation group of companies transferred to General Investment Corporation for \$250,000,<sup>434</sup> 6,250 shares, or one-quarter of its total interest in Washington & Suburban Companies. General Investment Corporation in 1931 purchased the interest of United States & Overseas Corporation in this venture for \$600,000, or at a profit to United States & Overseas Corporation of

<sup>427</sup> *Id.*, at 25580.

<sup>428</sup> *Op. cit. supra*, note 316, Vol. 52, at 977 et seq.

<sup>429</sup> *Op. cit. supra*, note 1, at 25580.

<sup>430</sup> *Id.*, Commission's Exhibit No. X4136.

<sup>431</sup> *Id.*, Commission's Exhibit No. X4126. The contract also provided that Central Public Service Company might accelerate the sale and receive a discount on the price and also that the organizers of Washington & Suburban Companies would be entitled at their option to receive Class A common stock of Central Public Service Corporation in lieu of the agreed cash consideration for their shares in Washington & Suburban Companies.

<sup>432</sup> Schoellkopf, Hutton & Pomeroy disposed of \$900,000 of their \$1,000,000 interest in Washington & Suburban Companies to Niagara Share Corporation, Bennie Securities Corporation, Marine Union Investors, Inc., American Alliance Investing Corporation, and Liberty Shares Corporation. (*Id.*, Commission's Exhibit No. X4127.) H. M. Bylesby & Co. apparently transferred its entire \$1,000,000 interest in Washington & Suburban Companies to Utility and Industrial Corporation, an investment company which it sponsored and managed. (Reply to the Commission's questionnaire for Utility and Industrial Corporation, Pt. 3, Table 2, and Pt. 1, pp. 3 and 4.)

<sup>433</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. X3962, Schedule 21.

<sup>434</sup> *Id.*, Commission's Exhibit No. X4274.

\$99,500.<sup>435</sup> Thus, General Investment Corporation invested \$900,000 (including a \$99,500 profit to its own subsidiary, United States & Overseas Corporation) in Washington & Suburban Companies. General Investment Corporation was thus caused by its investment banker sponsor, Harris Forbes & Company to invest in Washington & Suburban Companies which had been formed to enable Central Public Service Company, a banking client of Harris, Forbes & Company, to acquire Washington Gas Light Company on a deferred payment plan.

Mr. Burroughs testified that the transfer by investment bankers to their sponsored investment companies of participations in banking transactions of the type exemplified by Washington & Suburban Companies was undesirable. However, he contended that the investment of United States & Overseas Corporation and of General Investment Corporation in Washington & Suburban Companies was in line with the announced policy of these investment companies to acquire the equity securities of public-utility companies.<sup>436</sup>

Q. Was that the type of business that you think investment trusts and investment companies should be in?

A. Yes; I think it is a fine business. If you could invest \$5,000,000, carry it two years, and make a million plus interest, that is good business for anybody.

Q. I am not referring to P. U. H. as participants. I am referring to the Schoellkopf, Hutton group of companies and to the Founders group.

A. I was not passing on whether or not it was appropriate for them. I consider that it was definitely in line with United States & Overseas' objectives, because we considered that it was just what United States & Overseas was formed for. It certainly fitted in with United States & Overseas.

\* \* \* \* \*

A. But I had nothing to do with that. I didn't think about it. It was no concern to me that Byllesby elected to pass their participation on to Utility and Industrial<sup>437</sup> or that Schoellkopf, Hutton passed it on to somebody else.<sup>438</sup>

Q. I am talking about an abstract proposition at this time, whether or not it is a good thing for investment bankers to pass the burden of carrying the investment over to investment companies.

A. I think it is not.

Q. You don't think it is a good practice?

A. No; I think it is a bad idea.

\* \* \* \* \*

A. There presumably would be a liberal profit to the investment trust but to answer your question, I don't think it is good for investment bankers to pass on this sort of investment to investment trusts. No; I don't think it is a good thing for investment bankers to be tied up with investment trusts.

From the time it borrowed the \$10,300,000 from the banks to acquire the Washington Gas Light Company stock, Washington & Suburban Companies had no apparent means of repaying the loans other than by the sale of its holdings of the stock of Washington Gas Light Com-

<sup>435</sup> Id., Commission's Exhibit No. X3962, pp. 21 and 29. This profit was an intercompany profit and in effect added no cost to General Investment Corporation which had a 97% interest in United States & Overseas Corporation at that time.

<sup>436</sup> Id., at 25585-6.

<sup>437</sup> See note 432, *supra*.

<sup>438</sup> Ibid.

pany, a substantial amount of which were pledged as security for the bank loans.<sup>439</sup> Earnings available to Washington & Suburban Companies on its holdings of Washington Gas Light Company common stock were insufficient even to cover the interest payments which Washington & Suburban Companies was required to make on its bank loans.<sup>440</sup> By October 1929 Washington & Suburban Companies already had an operating deficit of \$118,888.<sup>441</sup> Moreover, the possibility was present that Washington & Suburban Companies might be compelled by the District of Columbia Public Utility Commission to liquidate immediately at a possible large loss its controlling holdings of Washington Gas Light Company under the provisions of the Federal law forbidding the ownership of control, directly or indirectly, of a District of Columbia public utility company by any other corporation.<sup>442</sup>

As has been stated, the obligations of Washington & Suburban Companies to various banks, amounting to \$10,300,000, matured on April 19, 1930. To supply the funds to meet these obligations, a subsidiary of Central Public Service Corporation offered its debentures to the public, through Harris, Forbes & Company. Thus, as a result of the formation of Washington & Suburban Companies, Harris, Forbes & Company was enabled to derive additional banking business and underwriting commissions.

In March 1930, Southern Cities Public Service Company, which committed itself to purchase all of the stock of Washington & Suburban Companies on April 30, 1931, entered into an agreement to purchase from Washington & Suburban Companies \$10,300,000 of the latter's one-year notes at 98¾% of their face value.<sup>443</sup> The proceeds of these notes were to be used by Washington & Suburban Companies to meet its bank loans.<sup>444</sup>

Simultaneously, Southern Cities Public Service Company entered into an agreement with Harris, Forbes & Company whereby Southern

<sup>439</sup> Subsequently the bank loans borrowed by Washington & Suburban Companies were repaid with funds advanced to Washington & Suburban Companies by Southern Cities Public Service Company, one of the companies of the Central Public Service system. (See note 316, *supra*.) These loans in turn were repaid by the issuance to Southern Cities Public Service Company of \$6,500,000 principal amount of the bonds and 700,000 shares of the preferred stock of Washington & Suburban Companies. (See notes 442 and 446, *infra*.)

<sup>440</sup> *Op. cit. supra*, note 1, at 25577. Washington Gas Light Company was then earning about \$3.70 per share of common stock per annum. Accordingly the earnings on the 109,181 shares of such stock held by Washington & Suburban Companies were about \$400,000 as against the \$618,000 interest accruing on the trust's bank loans, totaling \$10,300,000.

<sup>441</sup> *Id.*, at 25562-3.

<sup>442</sup> In fact, shortly after Washington & Suburban Companies acquired control of Washington Gas Light Company proceedings were instituted in the District of Columbia District Court by the District of Columbia Public Utility Commission to compel Washington & Suburban Companies to dispose of its holdings in Washington Gas Light Company. The Court, however, dismissed the proceedings on the ground that the La Follette Antimerger Statute did not in terms forbid the acquisition of control of District of Columbia public-utility companies by common-law trusts. No appeal was taken by the District of Columbia Public Utility Commission from this decision. (*Op. cit. supra*, note 316, Vol. 52, at 361-70), but in May 1932 the Commission ordered Washington & Suburban Companies to dispose of its control of Washington Gas Light Company. This order, however, was later rescinded by the Commission. (*Op. cit. supra*, note 1, Commission's Exhibit No. X4139.)

<sup>443</sup> As consideration for this undertaking on the part of Southern Cities Public Service Company, Central Public Service Company agreed to assign to it its right to purchase all of the shares of Washington & Suburban Companies. (*Op. cit. supra*, note 316, at 978.)

<sup>444</sup> *Id.*, at 978.



Cities Public Service Company sold \$10,500,000 principal amount of its own one-year notes at 97¾% of their face value to Harris, Forbes & Company,<sup>445</sup> for distribution to the public; the proceeds of such notes were advanced by Southern Cities Public Service Company to Washington & Suburban Companies, which used them to repay its bank loans.<sup>446</sup>

As has been stated, Central Public Service Company was obligated to purchase, on April 30, 1931, the shares of beneficial interest in Washington & Suburban Companies held by General Investment Corporation and others, at a total cost of \$6,000,000. On March 15, 1931, however, this commitment on the part of Central Public Service Company was in effect extended until April 30, 1932, by the following plan. Colonel A. E. Pierce, the controlling personality in the Central Public Service Company System, organized the Westfield Trust, another Massachusetts trust, and contributed \$10,000 as its capital. Westfield Trust then purchased from the shareholders of Washington & Suburban Companies all of their stock and the trust issued to the shareholders as the purchase price, \$6,000,000 of its collateral trust notes secured by all the stock so acquired.<sup>447</sup> The notes of Westfield Trust were guaranteed by Central Public Service Company.<sup>448</sup>

On April 30, 1932, when its notes matured, Westfield Trust defaulted in payment.<sup>449</sup> Central Public Service Company, the guarantor of the notes, was apparently insolvent at that time.<sup>450</sup> General Investment Corporation, as syndicate manager for the noteholders, foreclosed and purchased the Washington & Suburban Companies stock securing the \$6,000,000 notes for the face amount of the notes plus interest accrued and incidental expenses.<sup>451</sup> For its participation of \$900,000, General Investment Corporation acquired 900 shares of Washington & Suburban Companies' stock at the principal amount of \$900,000 to which was added \$67,126.50 accrued interest and expense. In 1935 this investment was written down to \$1.<sup>452</sup>

## 8. LOAN BY GENERAL INVESTMENT CORPORATION TO BUENOS AIRES CENTRAL RAILROAD AND TERMINAL COMPANY—LOSS, \$6,780,974.46

Another venture in which the funds of General Investment Corporation were caused to be invested was the financing of a subway construction program of Buenos Aires Central Railroad and Terminal Company, hereafter referred to as the Terminal Company. This investment was placed in the investment company after the break in the securities market apparently in order to relieve Harris, Forbes

<sup>445</sup> *Ibid.*

<sup>446</sup> Subsequently, Washington & Suburban Companies in repayment of its \$10,300,000 obligation to Southern Cities Public Service Company issued to the latter company \$6,500,000 principal amount of its notes and 700,000 shares of its preferred stock. (*Id.*, at 979.)

<sup>447</sup> *Id.*, at 980-1.

<sup>448</sup> *Ibid.*

<sup>449</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. X4138.

<sup>450</sup> The assets of Central Public Service Company at April 30, 1932, totaled \$125,000 as compared with its guaranty of the \$6,000,000 principal amount of Westfield Trust notes. (*Id.*, at 25673.)

<sup>451</sup> *Id.*, Commission's Exhibit No. X4138.

<sup>452</sup> *Ibid.* and Commission's Exhibit Nos. X3423-B (p. 9) and X3423-5j (p. 4).



& Company of the burden of financing this project. As a result, General Investment Corporation invested \$14,280,974.46 in the Terminal Company and eventually lost \$6,780,974.46 (before payment of commissions on the sale thereof).

Harris, Forbes & Company first became interested in the Terminal Company's financing in 1926,<sup>453</sup> when Mr. Burroughs met Lando Tiofile Lacroze, a member of a family which controlled a power company and a tramway system in Buenos Aires, and a railroad in the Argentine. The family also owned a perpetual federal concession for the construction and operation of a subway from the terminal of the railroad on the outskirts of Buenos Aires to the center of that city and from that point to the railroad yards and harbor facilities.

At that time certain Anglo-Argentine interests were successfully operating a subway in Buenos Aires under a municipal concession, and it was thought that the Lacroze concession would be even more profitable because of its more favorable terms.<sup>454</sup>

In order to finance construction of the subway, the Lacroze family, at the suggestion of Harris, Forbes & Company, created the Terminal Company as a holding company and acquired all its common stock in consideration for the transfer by the members of the family to the Terminal Company of their interest in the railroad, tramline, electric company, and subway concession.<sup>455</sup> Thereupon, Harris, Forbes & Company distributed in London \$6,000,000 of the preferred stock of the Terminal Company and the proceeds were used to start the construction of a subway in Buenos Aires.<sup>456</sup>

At about the time construction started, Harris, Forbes & Company represented<sup>457</sup> to the Terminal Company in writing that the firm

<sup>453</sup> Id., at 25492-3.

<sup>454</sup> Ibid. The Lacroze concession, which was a perpetual federal franchise provided for a franchise tax of only 3% of net income, and permitted duty-free import of all materials used in construction. The Anglo-Argentine interests had been forced to pay duty on construction materials, operated under a limited municipal franchise, and paid a tax of 6% of gross income.

<sup>455</sup> Id., at 25492-5.

<sup>456</sup> Ibid.

<sup>457</sup> Harris, Forbes & Company was advised by its counsel that, by reason of a provision in the contract entitling Harris Forbes & Company to cancel the contract if in its sole opinion market conditions were unfavorable to a public offering of the bonds, it had assumed no firm liability to the Terminal Company. Mr. Burroughs testified (id., at 25497-8):

A. \* \* \* We did not want this contract by any possibility to be a firm obligation. We wanted it to have a wide open force majeure that would protect us against any firm obligation.

Q. What use was such a contract to the Buenos Aires Railway?

A. Oh, I think Mr. Lacroze felt that if we had an agreement or understanding reduced to writing that he was pretty well assured that his project would be financed.

Q. Even though he could not enforce it?

A. Even though he could not enforce it. He was not primarily interested in having a firm obligation. In fact it would have been practically impossible for anyone to enter into a firm obligation as far in the future as that contract was covered.

Q. \* \* \* Well, assuming that it would be so, I am wondering what Mr. Lacroze gets out of such a document.

A. Oh, I think he wanted it primarily to show his associates in the Argentine that he really had an associate or understanding rather with American banking associations. We were interested more from the standpoint of tying up the business. We did not want to have placed the preferred stock in London and then wake up to find Lacroze had sold the bonds to some of his British bankers that he had previously raised money with. All of his business connections had been with British banking companies, and we wanted to be assured we had control.

Q. And this gave you this control without making any commitments on your part?

A. Yes; we were satisfied that Lacroze would live up to the spirit of it, and he was satisfied that we would.

Q. So that really it was a moral rapprochement between you in his feeling that he had you more or less morally tied up, and you feeling you had him more or less morally tied up.

A. We certainly wanted to go through with the project because we had marketed the preferred stock in London. We felt a responsibility to the preferred stockholders to see that a reasonable effort was made to carry this project through to completion.

would distribute publicly in the United States, before April 1, 1928, a \$10,000,000 mortgage bond issue of the Terminal Company. When the proceeds of the Terminal Company's preferred-stock issue distributed by Harris, Forbes & Company had been expended, Harris, Forbes & Company took advantage of its privilege to extend the time under which it might market the Terminal Company's bonds.<sup>458</sup> However, in order to provide funds necessary to continue the subway construction, Harris Forbes & Company made arrangements for such construction to be financed temporarily by bank loans<sup>459</sup> made by the Guaranty Trust Company of New York. By July 1929, loans to the Terminal Company made by the Guaranty Trust Company totaled \$5,250,000. In July 1929, Harris, Forbes & Company informed the Guaranty Trust Company of its intention to refund the bank's loans to the Terminal Company by the sale of the Terminal Company's bonds when the market was propitious.<sup>460</sup>

On October 1, 1929, just before the stock-market break, Harris, Forbes & Company again extended the time, during which it might market the Terminal Company's bonds, until December 31, 1929.<sup>461</sup> Harris, Forbes & Company arranged for an extension of the Terminal Company's loans at the Guaranty Trust Company and again represented to the bank that the firm would distribute a bond issue for the Terminal Company,<sup>462</sup> the proceeds of which would be used to pay off these loans. Mr. Burroughs testified:<sup>463</sup>

A. We borrowed money from the Guaranty as work progressed, and it was done that way in order to save interest instead of borrowing \$5,000,000 at the outset, we borrowed one or two and a half million, and then later borrowed some more, and then every time that the Terminal Company got a loan from the Guaranty, or renewed its loan, Harris Forbes wrote the Guaranty a letter assuring them that it was still the intention of Harris Forbes to market an issue of bonds when and as market conditions, and so forth, were propitious.

Q. So the Guaranty Trust Company knew at all times that it was your intention to market these bonds?

A. Yes; they certainly did. On the other hand, they were fully aware of the provisions. The Guaranty Trust Company at that time was very anxious to develop this financial connection in Buenos Aires, because all American banks were looking for opportunities to expand, and the First National Bank of Boston and the National City of New York were the large American banks represented in the Argentine, and this was an opportunity for the Guaranty to make a connection with a large Argentine enterprise, and looked forward to it as a very important connection.

Q. At the time, I take it, that the loans were made by the Guaranty Trust, the Guaranty Trust was fully aware of the existence of this agreement. You stated, I think——

A. Oh, yes; they were fully aware, knew all about it.

Q. And as a matter of fact, when this expression of intention on your part to take these bonds was extended from time to time, the extensions seemed to be timed with the maturity of the Guaranty Trust loans?

A. Well, I think the letters were given at the time there was a renewal.

<sup>458</sup> Id., at 25495-6 and Commission's Exhibit No. X3994.

<sup>459</sup> Id., at 25495-6.

<sup>460</sup> Id., at 25502-3, 25505.

<sup>461</sup> Id., Commission's Exhibit No. X3994.

<sup>462</sup> Id., at 25505.

<sup>463</sup> Id., at 25503-6.

Q. Well, there is not in your—there can't be very much doubt about it because it is stated, "In connection with the loan you are making with the Guaranty Trust in the amount of \$5,250,000, maturing on or before December 31, we desire to renew the statement." There isn't any doubt that these were timed——

A. None at all.

Q. Did the Guaranty Trust consider your assurance of some materiality in making its loans?

A. I had a good deal of experience at that time making similar loans for other enterprises, negotiating with the bank, and the bank would say, "Is this something you are expecting to handle the securities, or is it something we will have to look to somebody else," and I would say, "No: this is leading up to a bond issue we expect to place. We have not made any definite arrangements as to terms or conditions." That is all the banks wanted at that time. At those times banks were glad to make loans to a company where they felt the company had established relations with an investment house and some issue would be forthcoming when it was needed. Today a bank would probably want a firm commitment.

Q. But the Guaranty Trust would not take it very kindly if you had just stepped out of the picture and left them on the loan, if they had not received some substitute or some other assurance that the financing would be carried through?

A. Oh, no. I don't think they would.

When the Terminal Company's \$5,250,000 obligation to the Guaranty Trust Company matured on December 31, 1929 (after the collapse of the securities markets in October 1929), the Terminal Company did not have the funds to meet the loan. Harris Forbes & Company believed that it would be unable to market an issue of the Terminal Company's bonds except at a high interest rate<sup>461</sup> and apparently the banking firm did not desire to do that. Whether or not Harris, Forbes & Company was legally obligated by reason of having represented to the Guaranty Trust Company that it (Harris, Forbes & Company) intended to distribute a bond issue for the Terminal Company, and thus provide the funds to meet the maturity of the bank's loan to the Terminal Company, Harris, Forbes & Company was in a predicament. The Guaranty Trust Company had made these \$5,250,000 of loans to the Terminal Company, partly in reliance upon the representation of Harris, Forbes & Company that that firm intended to market a bond issue for the Terminal Company, the proceeds of which would be used to pay off these loans. Because of the stock-market crash in October 1929 Harris, Forbes & Company could not distribute an unguaranteed 6% issue and would not distribute an 8% issue for the Terminal Company. Moreover, as has been indicated, Harris, Forbes & Company had sold to the English public the preferred stock of the Terminal Company. And, as Mr. Burroughs testified,<sup>465</sup> the firm felt it necessary to protect the preferred stockholders against a possible loss which might accrue to them if the construction of the subway of the Terminal Company were not completed because of financial difficul-

<sup>461</sup> Mr. Burroughs testified (*id.*, at 25518) :

Q. In your opinion, were market conditions such that bonds of the Buenos Aires Railroad could have been marketed directly in the United States at that time?

A. I think they might with the 8-percent coupon \* \* \*. They could not have been marketed at 6 percent.

<sup>465</sup> *Id.*, at 25498.

ties. In addition, the failure of Harris, Forbes & Company to procure financing for the Terminal Company might have resulted in the loss of its banking contract with that company. And finally the Guaranty Trust Company "would not take it very kindly" if Harris, Forbes & Company "had just stepped out of the picture and left them [the bank] on the loan." It evidently was incumbent upon Harris, Forbes & Company to devise some means whereby the Terminal Company could raise funds to pay off these bank loans.

The following plan was therefore evolved by Harris, Forbes & Company to extricate itself from its predicament. On February 3, 1930, the United States & Overseas Corporation was caused to loan to the Terminal Company \$1,000,000, which was deposited to the account of the Terminal Company with the Guaranty Trust Company.<sup>466</sup>

On December 31, 1929, South American Railways Company<sup>467</sup> was incorporated as a subsidiary of General Investment Corporation with paid-in capital of \$1,510,000,<sup>468</sup> of which \$10,000 was contributed by General Investment Corporation. On March 31, 1930, General Investment Corporation lent \$7,500,000 to South American Railways Company for sixty days.<sup>469</sup> This money was in turn lent to the Terminal Company,<sup>470</sup> which used it to pay its debt of \$5,250,000 to the Guaranty Trust Company and its debt of \$1,000,000 to United States & Overseas Corporation.<sup>471</sup>

In order to finance the balance of the Terminal Company's subway construction and to pay off its loan from General Investment Corporation, South American Railways Company on April 28, 1930, sold at 97% to Harris Forbes & Company \$12,000,000 principal amount of its 6% notes due April 15, 1933, guaranteed both as to interest and principal by General Investment Corporation and convertible into General Investment Corporation common stock.<sup>472</sup> These notes were then distributed by Harris, Forbes & Company to the American public at par.<sup>473</sup> On the same date General Investment Corporation purchased from South American Railways Company 20,000 shares of its preferred and 20,000 shares of its common stock for \$1,000,000.<sup>474</sup> Out of the proceeds of the sales of the notes and stocks, South American Railways Company repaid its \$7,500,000 loan from General Investment Corporation and lent an additional \$7,000,000 to the Terminal Company.<sup>475</sup> As a result of the above-described transactions, General Investment Corporation and United States & Overseas Corporation in-

<sup>466</sup> Id., Commission's Exhibit No. X3995.

<sup>467</sup> *Poor's Fiscal Volume*, 1931, p. 1142.

<sup>468</sup> South American Railways Company issued 230,000 shares and 30,000 preferred shares for \$1,510,000. Of this, 200,000 shares of common were issued to General Investment Corporation for \$10,000 and the remaining shares in three equal lots were issued to United States & Overseas Corporation, First National-Old Colony Corporation and United Engineers Society for \$500,000 cash each. (Op. cit. supra, note 1, Commission's Exhibit No. X3996). The First National-Old Colony Corporation was identified as affiliated with First National Bank of Boston (id., at 25511), one of the sponsors of United States & Overseas Corporation.

<sup>469</sup> Id., Commission's Exhibit No. X3996.

<sup>470</sup> Id., Commission's Exhibit No. X3997.

<sup>471</sup> Id., Commission's Exhibits Nos. X3995, X3996.

<sup>472</sup> Id., at 25517-20.

<sup>473</sup> Ibid.

<sup>474</sup> Id., Commission's Exhibit No. X3996.

<sup>475</sup> Id., Commission's Exhibit No. X3997.

vested in South American Railways Company a total of \$14,520,000. Of this amount, General Investment Corporation had contributed \$1,020,000 and guaranteed payment on \$12,000,000 of South American Railways Company's notes; while United States & Overseas Corporation had contributed \$500,000. Thus by causing General Investment Corporation, with its \$60,000,000 of South American Railways Company assets, to guarantee a \$12,000,000 note issue, Harris, Forbes & Company succeeded in raising sufficient funds not only to pay off the bank loans but complete the construction of the subway. In addition, General Investment Corporation and United States & Overseas Corporation were caused to invest indirectly \$1,500,000 for the same purposes.

Mr. Burroughs testified: <sup>476</sup>

Q. But the fact is that, whether this was a commitment or whether it was not the whole thing was settled largely by Public Utility Holding Company, General Investment Corporation guaranteeing a bond issue of South American Railways which Harris Forbes took over?

A. Harris Forbes marketed the issue.

Q. And it was guaranteed by Public Utility Holding Corporation?

A. That is correct.

Q. And the Guaranty Trust Company was paid off?

A. That is correct.

Q. So that as far as any embarrassment on that score, Harris Forbes had no embarrassment from this commitment or this arrangement?

A. No; Harris Forbes never had any embarrassment at all.

Q. But Public Utility Holding Corporation had some difficulty, didn't it?

A. At maturity?

Q. Yes; I mean its guarantee was a real obligation.

A. Was a very real obligation.

Q. And involved very real misfortune?

A. Very real.

The notes of South American Railways Company at maturity became a "live" obligation of General Investment Corporation, which had guaranteed the issue.<sup>477</sup> To reduce this obligation, General Investment Corporation invited tender by the public of the South American Railways Company notes<sup>478</sup> and acquired the entire \$12,000,000 issue at a cost of \$9,882,494.<sup>479</sup>

During the period of acquisition of the \$12,000,000 of South American Railways Company notes, General Investment Corporation lent the Terminal Company directly about \$2,868,680.<sup>480</sup> This increased the aggregate investment of General Investment Corporation and United States & Overseas Corporation in the South American Railways Company to about \$14,260,680. General Investment Corporation thereafter acquired the South American Railways Company stock

<sup>476</sup> Id., at 25505-6.

<sup>477</sup> Id., at 25506-7.

<sup>478</sup> Id., Commission's Exhibit No. X3999.

<sup>479</sup> Id., Commission's Exhibit No. X3998. General Investment Corporation paid for these notes \$5,059,000 in cash and \$4,823,000 by the issue of its own notes.

<sup>480</sup> Id., at 25513-4; see also Commission's Exhibit No. X3996.

held by others<sup>481</sup> at a cost of \$19,800,<sup>482</sup> thus increasing its total investment in the South American Railways Company to about \$14,280,974.<sup>483</sup>

On November 6, 1934, South American Railways Company was liquidated and thereafter General Investment Corporation held directly the notes of the Terminal Company having a face value of \$17,496,771.<sup>484</sup>

In November 1936, after the control of General Investment Corporation had been sold to one Ernest B. Warriner, these notes of the Terminal Company, which had cost General Investment Corporation \$14,280,974, were sold for \$7,500,000, or a loss of \$6,780,974.46. This amount was not the entire loss on this venture, since a \$35,000 commission was paid to Clifford P. Billings and since \$250,000 was paid to one Philip De Ronde, ostensibly as his commission on the sale of the note and \$150,000 was paid ostensibly to a group of South American bankers.<sup>485</sup>

## **F. Repurchases of Preferred Stock; Profits to George E. Devendorf, President of General Investment Corporation, and Other Insiders**

In 1930, the Chase Securities Corporation by purchasing Harris, Forbes Companies, the parent company, had acquired control of all of the various Harris, Forbes companies, including a half interest in Public Utility Associates, Inc., formerly known as The Harris, Forbes Corporation.<sup>486</sup> As has already been shown, The Harris, Forbes Corporation held one-half of the Class A stock of General Investment Corporation. In July 1933 the stock of The Chase Securities Corporation was distributed to the stockholders of the Chase National Bank of the City of New York in compliance with provisions of the National Banking Act of 1933 requiring national banks to sever their connection with security affiliates.<sup>487</sup> At this time, United Founders Corporation took over the active management of General Investment Corporation by designating a majority of the investment company's board of directors.<sup>488</sup> By July 15, 1933, The Equity Corporation (another investment company then controlled by David Milton and Ellery Huntington) had acquired control of United Founders Corporation and its subsidiaries.<sup>489</sup> On November 23, 1935, The Equity Corporation caused United Founders Corporation and its subsidiaries to be consolidated to form American General Corporation,<sup>490</sup> 39% of the voting stock being acquired by The Equity Corporation.<sup>491</sup>

Beginning in November 1935, the United Founders Corporation group and its successor, American General Corporation, purchased

<sup>481</sup> See *supra*, note 468.

<sup>482</sup> *Op. cit. supra*, note 1, Commission's Exhibit No. X4000.

<sup>483</sup> *Id.*, at 25514.

<sup>484</sup> *Id.*, at 25509 and Commission's Exhibits Nos. X3996, X3997, and X3423-5i (p. 4).

<sup>485</sup> For more detailed discussion of this sale and commission see *infra*, pp. 595-601.

<sup>486</sup> See note 3, *supra*.

<sup>487</sup> *Op. cit. supra*, note 1, at 25292.

<sup>488</sup> *Id.*, Commission's Exhibit No. X3424 (p. 16).

<sup>489</sup> Public Examination, The Equity Corporation, Commission's Exhibits Nos. 805, 806. For more detailed discussion of The Equity Corporation see Sec. VI, N. *supra*, pp. 218-20.

<sup>490</sup> *Id.*, Commission's Exhibit No. 862.

<sup>491</sup> See Part Two (House Doc. No. 70, 76th Cong.), Ch. V. Sec. IV, B. 2.

all of the stock of Public Utility Associates, Inc.,<sup>492</sup> whose principal asset was its ownership of 50,000 shares of the Class A stock of General Investment Corporation—half of the outstanding shares of such stock. This purchase placed all of the Class A stock of General Investment Corporation, which represented 40% of that company's total voting power, in the hands of American General Corporation.<sup>493</sup>

From July 1933 to August 1936, under the management of United Founders Corporation and its successor American General Corporation, the activities of General Investment Corporation<sup>494</sup> were primarily confined to the liquidation of its portfolio of public utility securities.<sup>495</sup> The funds derived from the sale of these portfolio securities were used by General Investment Corporation to reacquire its own outstanding preferred stock at substantial discounts from asset value, by means of exchange offers of cash and its common stock and of a new \$3 prior preferred stock.<sup>496</sup>

As at May 31, 1934, General Investment Corporation had outstanding 127,013 shares of \$6 preferred stock<sup>497</sup> having a preference in assets of \$115 a share, or a total of \$14,606,500. In addition, dividend arrears on the preferred stock then totaled \$1,905,000.<sup>498</sup> Thus, the total prior claim of the preferred stock against the investment company's assets was \$16,511,500. However, as at May 31, 1934, the investment company had net assets of \$12,147,877,<sup>499</sup> an amount insufficient to meet the preferential claim of the preferred stock against the assets of the company. As a result, the investment company's Class A common and common stocks had no asset value and the actual liquidating value of each share of preferred stock was \$95.64.

On May 31, 1934, the United Founders Corporation group held 50,000 shares of the Class A and 148,780<sup>500</sup> shares of the common

<sup>492</sup> One-half of the stock of Public Utility Associates, Inc., was acquired from George E. Devendorf, then president of General Investment Corporation, who had purchased the stock at a cost of \$75,000 in July 1935 from Amerex Holding Corporation, formerly Chase Securities Corporation. (Op. cit. supra, note 1, at 25293 and Commission's Exhibit No. X4130.) Mr. Devendorf transferred the stock of Public Utility Associates, Inc., to United Founders Corporation and American Founders Corporation in November 1935 in consideration of the receipt of 3,500 shares of the preferred and 25,000 shares of the common stock of General Investment Corporation which Mr. Davendorf resold at a profit of \$295,000. (Id., at 25664 and Commission's Exhibit No. X4130.)

<sup>493</sup> United Founders Corporation and its subsidiaries, the predecessors of American General Corporation, had held 50% of the Class A stock of General Investment Corporation from the latter's inception in 1929. (Id., Commission's Exhibit No. X3424 (p. 27 et seq.).)

<sup>494</sup> Id., Commission's Exhibit No. X3423-c, Item 19.

<sup>495</sup> Upon its accession to control, United Founders Corporation caused the name of the investment company to be changed from The Public Utility Holding Corporation of America to its present name, General Investment Corporation. (Id., Commission's Exhibit No. X3423, p. 1.)

<sup>496</sup> Op. cit. supra, note 1, Commission's Exhibit No. X4129. This new preferred stock, which was created by an amendment to the investment company's charter on September 25, 1934, had a par value and liquidating preference of \$50 per share.

<sup>497</sup> Id., Commission's Exhibit No. X3423-5-H. The investment company also had outstanding as of the same date 626,698 shares of common stock and 100,000 shares of Class A stock alike in all respects except that the Class A stock at all times possessed 40% of the voting power of the corporation.

<sup>498</sup> Ibid.

<sup>499</sup> Ibid. The investment company's then principal asset, the notes of the Buenos Aires Central Railroad & Terminal Company having a face value of \$17,410,565 (ibid.), were valued on the company's balance sheet, after deducting reserves, at approximately \$7,000,000. (Ibid.) As will be described infra (pp. 592-4), these notes were later sold to an agency of the Argentine government for \$7,500,000.

<sup>500</sup> Id., Commission's Exhibit No. X3424 (p. 27 et seq.).



stock of General Investment Corporation, or approximately 27% of the aggregate of such common and Class A stock then outstanding.<sup>501</sup> The retirement of substantial blocks of the investment company's preferred stock at a cost less than the actual liquidating value would, at the expense of preferred stockholders who sold their shares for less than asset value, not only enhance the liquidating value of the outstanding preferred stock and eliminate dividend arrearages on the preferred stock retired, but would increase the possibility of participation in the company's assets and earnings by the common and Class A common stockholders.

On June 15, 1934, General Investment Corporation, then under the control of the United Founders Corporation group, offered to acquire its \$6 preferred stock by payment of \$15 in cash and 7 shares of its common stock for each share of such preferred stock.<sup>502</sup> The management's offering letter invited tenders up to a maximum of 42,337 shares, one-third of the total amount outstanding, to be made on June 30, 1935.<sup>503</sup> The letter inviting tender did not disclose either the market or the asset value of the securities involved in the exchange.<sup>504</sup> Nor did the letter indicate the management's holdings of the common and Class A common stock of the company and the possible benefit which might accrue to the management by virtue of these holdings, if the offer was successful.

On June 15, 1934, the market value of the \$6 preferred stock was approximately \$15 a share and the market value of the company's common stock was 75 cents per share. On a market value basis, therefore, the company's offer of \$15 in cash plus 7 shares of common stock having a market value of \$5.25 for each share of its \$6 preferred stock was an attractive one.<sup>505</sup> However, the preferred stockholders who accepted the company's offer received \$15 cash and common stock having no asset value in return for each share of their preferred stock which had an asset value on May 31, 1934, according to the company's published reports, of \$95.64 per share.

<sup>501</sup> The United Founders Corporation group on May 31, 1934, also held 34,683 shares of the \$6 preferred stock of General Investment Corporation, equivalent to 27% of the 127,013 shares of such stock then outstanding. (Ibid.) Although they accepted the exchange offers of General Investment Corporation as to a portion of their holdings of such stock at a loss in asset value, this loss was in substance offset by the enhancement in the value of the preferred stock which the Founders group of companies retained. See *infra*, p. 581.

<sup>502</sup> *Op. cit.* *supra*, note 1, Commission's Exhibit No. X4129. On July 2, 1934, this offer was renewed and on July 30, 1934, the offer expired. (Ibid.)

<sup>503</sup> *Id.*, Commission's Exhibit No. X4129. It is to be noted that Section 3 (a) (9) of the Securities Act of 1933 exempts from the registration provisions of that Act "any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange."

<sup>504</sup> *Id.*, Commission's Exhibit No. X4129. Nor did the annual report of General Investment Corporation as of May 31, 1934, which was issued to the stockholders on June 12, 1934, specifically indicate the asset values of the company's outstanding securities, although it contained financial statements from which an informed investor, after some calculation, could obtain such asset values. (*Id.*, Commission's Exhibit No. X3423-5h.)

<sup>505</sup> This premium paid in terms of market value was an inducement for the exchange. However, since the market value of the common stock had no basis in underlying asset value, the advantage in the exchange to investors in General Investment Corporation as a whole was more apparent than real. While individual security holders might realize \$5.25 on resale of the common shares, they could realize it only by reason of the fact that others might buy from them stock which had neither asset value nor current earnings.



As a result of its offer, General Investment Corporation reacquired 42,337 shares, constituting one-third of its outstanding \$6 preferred stock, with a liquidating value, as of May 31, 1934, of \$95.64 per share or a total liquidating value of \$4,029,110. For these shares General Investment Corporation expended \$635,055 in cash and issued 296,359 shares of its common stock, without any asset value at that time. As a consequence, the asset value of the remaining preferred stock was enhanced by approximately \$3,414,055, at the expense of the preferred stockholders who had accepted the company's offer. Furthermore, by this retirement one-third of the \$1,905,000 of dividend arrearages on the preferred stock as of May 31, 1934, was eliminated.

The United Founders Corporation group of companies accepted General Investment Corporation's offer as to 11,653 shares of their total holdings of the 34,683 shares of \$6 preferred stock.<sup>506</sup> The United Founders Corporation group retained 23,030 shares<sup>507</sup> of the \$6 preferred stock of General Investment Corporation, or approximately the same proportion of the preferred shares outstanding as it had previously held. Since the asset value of only the preferred stock was affected by the exchange, the derived increment in the asset value of the preferred stock of General Investment Corporation which the United Founders Corporation group retained, approximately offset the loss in asset value in the preferred stock of General Investment Corporation which they surrendered under the offer.

On February 14, 1935, General Investment Corporation offered to acquire 59,230 shares, or 70% of its then outstanding \$6 preferred stock in exchange for shares of a new \$3 prior preferred stock and its common stock at the rate of one-half of a share of a new \$3 prior preferred stock and ten shares of common stock for each share of old preferred stock.<sup>508</sup> This offer was renewed on March 26, and on June 20, 1935, and expired on July 8, 1935.<sup>509</sup> Again the offering letters failed to disclose fully the asset and market values of the securities involved in the exchange or the management's holdings of the various classes of the investment company's securities.<sup>510</sup> The market value of the \$6 preferred stock during the pendency of this offer varied from \$15 to \$17 a share. The market value of the ten shares of common stock plus the one-half share of \$3 preferred stock offered for each share of the \$6 preferred stock over the same period was approximately \$30.<sup>511</sup>

However, stockholders who accepted the offer suffered substantial losses in asset values. During the pendency of these offers, the asset

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<sup>506</sup> *Id.*, Commission's Exhibit No. X3424 (p. 27 et seq.).

<sup>507</sup> *Ibid.*

<sup>508</sup> *Id.*, Commission's Exhibit No. X4129.

<sup>509</sup> *Ibid.* A cash offer of \$15 a share was made for the \$6 preferred stock held by stockholders owning 7½ shares or less of such stock.

<sup>510</sup> *Ibid.*

<sup>511</sup> *Id.*, Commission's Exhibit No. X3773. This valuation assumes a market value for the one-half share of \$3 prior preferred stock of \$25 a share, the amount of its preference against the investment company's assets.

value of the \$6 preferred stock was in excess of \$60 per share.<sup>512</sup> By July 24, 1935, the investment company had reacquired and retired as a result of the exchange offer 21,374 shares of its \$6 preferred stock having a total liquidating value of approximately \$1,282,440.<sup>513</sup> To reacquire these shares General Investment Corporation had issued 10,687 shares of \$3 prior preferred stock having a liquidating value of \$534,350<sup>514</sup> and 213,740 shares of its common stock having no asset value at the time. As a result of the exchange, therefore, the asset value of the outstanding \$6 preferred stock was enhanced approximately \$748,090.

The United Founders Corporation group accepted this last offer of the General Investment Corporation to the extent of 5,840 shares of their holdings of the \$6 preferred stock.<sup>515</sup> However, United Founders Corporation still retained 17,190 shares of the \$6 preferred stock,<sup>516</sup> thereby retaining approximately 27% of the 63,050 of such shares outstanding after the termination of the exchange offers.<sup>517</sup> Since the exchange only affected the asset value of the \$6 preferred stock still outstanding and the United Founders Corporation group retained their proportionate interest in this class of stock, the Founders group derived an increment in the asset value of the \$6 preferred stock of General Investment Corporation which they retained approximately equal to the loss in asset value they suffered on the \$6 preferred stock which they surrendered to General Investment Corporation.

In all, as a result of these exchange offers, General Investment Corporation reacquired 63,711 shares of its \$6 preferred stock, or approximately one-half of such preferred stock outstanding prior to the exchange offers, at a discount of about \$4,162,145 from their asset values at the approximate times of such offers. And, as has been stated, although the United Founders Corporation groups surrendered part of its shares of the \$6 preferred stock of General Investment Corporation under the terms of the latter's exchange offers, their losses in asset value, as the result of the exchanges, were offset by the increase in asset value of the \$6 preferred stock which they retained. How-

<sup>512</sup> On November 30, 1934, the asset value of the \$6 preferred stock was \$62 per share (id., Commission's Exhibit No. X3423 [Exhibit 5-1]) and on May 31, 1935, its asset value was \$67.69 per share. (Id., Commission's Exhibit No. 5-J.) The apparent decline in the asset value of the preferred stock from an asset value of \$95.64 per share on May 31, 1934, to \$67.69 per share on May 31, 1935, is attributable to an "arbitrary" write-down by the management of the notes of the Buenos Aires Central Railroad & Terminal Company from approximately \$7,000,000 on May 31, 1934, to approximately \$3,800,000 on May 31, 1935. (Ibid.) These notes, as already stated, were sold in November 1936 for \$7,500,000. If the valuation of \$7,000,000 for the Terminal Company's notes used in the May 31, 1934, report to stockholders had been retained in the May 31, 1935 report, the reported asset value of the \$6 preferred stock on this date would have been approximately \$115 per share.

<sup>513</sup> Id., Commission's Exhibit No. X3424 (p. 24).

<sup>514</sup> Ibid. On November 7, 1935, General Investment Corporation made a public offer to repurchase its \$3 prior preferred stock at a price of \$41.50 per share. As a result of this offer, the investment company reacquired 9,408 shares of \$3 prior preferred stock having a liquidating value of \$470,400 at a cost of \$390,331.50. (Id., Commission's Exhibits Nos. X4129, X3424 (p. 16).)

<sup>515</sup> These common shares, however, had a market value of approximately \$291,200. (Id., Commission's Exhibit No. X3773.)

<sup>516</sup> Id., Commission's Exhibit No. X3424 (p. 27 et seq.).

<sup>517</sup> Id., Commission's Exhibit No. X3423-5-I.

ever, the retirement of approximately one-half of the outstanding \$6 preferred stock of General Investment Corporation was of potential benefit to the Class A and common stock of General Investment Corporation which was substantially owned by the United Founders Corporation group.

Largely as the result both of the retirement of part of the company's \$6 preferred stock by exchange offers and the subsequent sale for \$7,500,000 gross of the notes of the Buenos Aires Central Railroad & Terminal Company to an agency of the Argentine government in November 1936,<sup>518</sup> the net assets of the investment company as at November 30, 1936 were not only sufficient to meet the full liquidating preference of the then outstanding \$6 preferred stock plus the unpaid dividends thereon, but also to provide an asset value of approximately 70 cents per share for the company's outstanding Class A and common stock.<sup>519</sup> However, American General Corporation (the successor to the United Founders Corporation group), did not obtain the full advantage of this increment because it disposed of its holdings of the securities of General Investment Corporation to International Equities Corporation, another investment company controlled by Ernest B. Warriner at a price of \$1,100,000 which was only \$32,000 in excess of the stated value of such holdings.<sup>520</sup> This price was substantially less than the asset value of the securities after the sale of the Terminal Company notes which took place a short time after American General Corporation sold its holdings to International Equities Corporation.

During the time that the investment company was engaged in its preferred stock retirement program substantial trading in this stock was carried on by the insiders of General Investment Corporation, particularly by George E. Devendorf and his family. In June 1932, Mr. Devendorf, who had served as vice president of the investment company from its inception, became its president and served in that capacity until August 3, 1936.<sup>521</sup> Although his ownership of General Investment Corporation's \$6 preferred stock prior to the time that he became president of the investment company had been limited

<sup>518</sup> As early as 1933, George E. Devendorf, then the president of General Investment Corporation, had gone to Buenos Aires in an attempt to dispose of the Terminal Company's notes held by the investment company. (Public Examination, General Investment Corporation, at 20237.) In a letter to the stockholders of General Investment Corporation, accompanying its annual report as of May 31, 1934, Mr. Devendorf stated (op. cit. supra, note 1, Commission's Exhibit No. X3423-5H): "According to latest advices received, the President of Argentina has recommended \* \* \* the enactment of a law providing for the formation of a transport monopoly to include the subways and tramways of the City of Buenos Aires and suburbs. It is too early to estimate the effect this law will have, if passed \* \* \* on the tramway and subway properties belonging to the Terminal Company." The law referred to in this letter was finally passed in October 1936. (Public Examination, General Investment Corporation, at 20238-9.)

<sup>519</sup> Op. cit. supra, note 1, Commission's Exhibit No. X3423-F.

<sup>520</sup> See infra. American General Corporation also received an 11% participation in any proceeds in excess of \$2,800,000 derived by General Investment Corporation from the sale by the latter of its holdings of the notes of the Buenos Aires Central Railroad & Terminal Company. This 11% participation would have entitled American General Corporation to an additional payment of \$517,000 from International Equities Corporation. However, in July 1937, for reasons which will be described later, American General Corporation took legal proceedings to rescind the sale of its holdings of General Investment Corporation's securities to International Equities Corporation.

<sup>521</sup> Op. cit. supra, note 1, Commission's Exhibit No. X3424, p. 16.

to 3¾ shares purchased for \$224.94 in September 1930,<sup>522</sup> after he became president Mr. Devendorf and his family became active traders in this stock. Between August 12, 1932, and March 9, 1934, Devendorf and his family purchased 14,295 shares of such preferred stock for \$86,696.75 or at an average price of \$6 a share; and between April 16 and July 19, 1934, at the time that the investment company was offering \$15 and 7 shares of common for each share of the \$6 preferred stock, Devendorf and his family resold these shares at an average price of \$12.40 per share for \$178,355.73 or at a profit of \$91,434.04.<sup>523</sup>

Between March 25, 1935, and June 19, 1935, Mr. Devendorf and his family purchased 2,852 shares of \$6 preferred stock of General Investment Corporation for \$60,365.05. Again at the time that the investment company was reacquiring its \$6 preferred stock by the further public exchange offers, these shares were sold for \$96,051.32 or at a profit of \$35,695.27.<sup>524</sup> Mr. Devendorf testified that these profits realized by him and his family on their transactions in the \$6 preferred in 1934 and 1935 were realized in part at the expense of the investment company to which he sold \$6 preferred stock, for cash and securities, at the times that the investment company made its exchange offers.<sup>525</sup>

In addition to the above preferred shares which were resold by Mr. Devendorf and his family during 1935, the Devendorfs during that year accumulated approximately 13,900 shares of the \$6 preferred stock at a cost of about \$267,520.<sup>526</sup> Almost immediately upon Mr. Devendorf's resignation as president of the Corporation in August 1936, he and his family resold 4,900 shares of this \$6 preferred stock at a profit of \$199,694.37.<sup>527</sup> Of these shares, 800 were sold to American Equities Corporation<sup>528</sup> at \$60 per share or at a profit of \$32,609.04.<sup>529</sup> These 800 shares together with 1,200 additional shares which American Equities Corporation had acquired at a total cost of \$103,170 (for the entire 2,000 shares) and 2,500 additional shares owned by Devendorf and his family were immediately resold to

<sup>522</sup> See Appendix F, *infra*.

<sup>523</sup> *Ibid*.

<sup>524</sup> *Ibid*.

<sup>525</sup> *Op. cit. supra*, note 1, at 25667. During 1935 General Investment Corporation paid out about \$1,299,000 in cash in retirement of preferred stock. (*Id.*, Commission's Exhibit No. X3424 at pp. 10-11.)

<sup>526</sup> Appendix F, p. 788.

<sup>527</sup> *Ibid*.

<sup>528</sup> While Devendorf was president of General Investment Corporation in November 1935, it sold to Colonel A. E. Pierce the entire block of 509,673 shares of Central Public Service Company common stock and of 249,467 shares of Central Public Utility Corporation Class A stock together with an option on 5,000 shares of Consolidated Electric & Gas Company preferred stock for \$70,000. Thereafter, Colonel Pierce sold these securities at a profit of over \$100,000 (*op. cit. supra*, note 1, at 25636-8) to American Equities Corporation which had been suggested to Pierce as a possible buyer of such securities by Mr. Devendorf. (*Id.*, at 25685.) This transaction gave American Equities Corporation a substantial interest in the reorganized Central Public Service system. Mr. Devendorf was then and still is chairman of the board of Consolidated Electric & Gas Company. (*Id.*, at 25669.) Almost immediately upon his resignation as president of General Investment Corporation in 1936, Devendorf started trading in the bonds of Consolidated Electric & Gas Corporation with funds loaned him by American Equities Corporation, such financing totaling \$118,728.77. (*Id.*, Commission's Exhibit No. X4145.)

<sup>529</sup> Appendix A, p. 779.

General Investment Corporation by American Equities Corporation on its own behalf and as agent for Devendorf and his family at \$60 per share or a profit of about \$101,900 to the Devendorfs and a profit of about \$17,000 to American Equities Corporation.<sup>530</sup>

American Equities Corporation was not the only associate of Mr. Devendorf to profit in trading in the \$6 preferred stock of General Investment Corporation. D. H. Silberberg & Company,<sup>531</sup> in 1935, bought in joint account with Mr. Devendorf and his family about 3,900 shares at \$20 per share which he resold to Wallace Groves<sup>532</sup> at a price of \$87.50 per share realizing thereby a profit of \$67.50 per share or a total profit of over \$263,000.

The balance of 9,000 shares of \$6 preferred stock which the Devendorfs held, at a cost of \$173,000, at the time of his resignation in August 1936 as president of General Investment Corporation were resold in January 1937 to Wallace Groves at \$87.50 per share or at a profit to the Devendorfs of about \$614,000.<sup>533</sup>

## G. MANAGEMENT OF GENERAL INVESTMENT CORPORATION BY ERNEST B. WARRINER (AUGUST 1936 TO MARCH 1937)

### 1. ACQUISITION OF CONTROL OF GENERAL INVESTMENT CORPORATION BY ERNEST B. WARRINER

In May 1936, American General Corporation (formerly United Founders Corporation group) controlled General Investment Corporation<sup>534</sup> by virtue of its ownership of 13,690 shares of the preferred stock, 97,000 shares of the Class A common stock, and 277,645 shares of the common stock.<sup>535</sup> At this time, General Investment Corporation, which had raised approximately \$78,500,000 of funds<sup>536</sup> had aggregate assets of only approximately \$5,400,000, consisting of \$1,099,351 in cash, portfolio securities with a market value of \$703,-

<sup>530</sup> Op. cit. supra, note 1, Commission's Exhibits Nos. X4145 and 4146: see Appendix A, infra. These shares were reacquired by exchange of Consolidated Electric & Gas Company preferred stock at \$15 a share. (Id., Commission's Exhibit No. X3970.) As indicated in note 528, supra, American Equities Corporation acquired a substantial interest in the reorganized Central Public Service Corporation System. The total investment therein on August 31, 1937, was in excess of \$1,000,000. (Id., Commission's Exhibit No. X4146.)

<sup>531</sup> D. H. Silberberg & Company, one of the principal brokers for the United Founders Corporation group, in 1929 managed Original Investing Corporation (id., at p. 25681), a private investment enterprise owned by Devendorf, partners of D. H. Silberberg & Company, and other officers of the United Founders Corporation group. (Id., at p. 25243.) D. H. Silberberg & Company had financed Devendorf's subscription to stock of that company. (Id., at p. 25243.)

<sup>532</sup> Id., at 25284.

<sup>533</sup> Appendix F, infra. As will be discussed later, this purchase by Wallace Groves involved no expenditure of his own funds but was in fact financed by General Investment Corporation which was at the time controlled by Ernest B. Warriner, a business associate of Wallace Groves. Simultaneous with the purchase Mr. Groves resold these and other preferred shares, the acquisition of which was similarly financed, to General Investment Corporation at a profit to him of about \$300,000.

<sup>534</sup> Public Examination, General Investment Corporation, at 15162-5.

<sup>535</sup> Id., Commission's Exhibit No. 1565.

<sup>536</sup> See supra, p. 502.

388, and the notes of the Buenos Aires Central Railway & Terminal Company<sup>537</sup> in which General Investment Corporation had invested a total of \$14,316,039.46<sup>538</sup> but which were valued, for balance-sheet purposes in May of 1936, at \$3,641,823.<sup>539</sup>

During 1933, General Investment Corporation commenced negotiations for the sale of the Terminal Company notes.<sup>540</sup> Clifford P. Billings,<sup>541</sup> vice president and general manager of the Terminal Company in Buenos Aires, was designated by General Investment Corporation to negotiate the sale of this investment to Argentine or British interests.<sup>542</sup> Mr. Billings, by March or April 1936, had succeeded in interesting the Instituto Mobilizador de Inversiones Bancarias, hereafter called the "Instituto," an Argentine governmental institution corresponding to the Reconstruction Finance Corporation,<sup>543</sup> in the possible purchase of the notes of the Terminal Company for \$6,500,000 in cash and "a secondary participation in the subway company." At that time, General Investment Corporation was still controlled by American General Corporation (formerly United Founders Corporation group), which in turn was controlled by The Equity Corporation, which in turn was dominated by the David Milton and Ellery C. Huntington interests.

About the time when Mr. Billings' negotiations to sell the Terminal Company notes were apparently succeeding, one Ernest B. Wariner, who had been associated with Wallace Groves when the latter

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<sup>537</sup> The investment in the notes of the Terminal Company constituted the only substantial asset of General Investment Corporation. Mr. Devendorf testified (op. cit. supra, note 534, at 15054) :

Q. The stockholders in this company, their only possible salvation to recoup at least a little of their losses, was in the subway ; isn't that so? That is the only substantial asset that they had at the time that you speak of, when you say the assets were nine to ten million dollars, isn't that so?

A. In August of 1936, that is correct.

Q. The only straw that the stockholders could grasp at, after the shrinkage of \$67,000,000 was that subway down in Buenos Aires?

A. That is correct.

<sup>538</sup> See Table 5, supra, p. 534.

<sup>539</sup> *Moody's Manual of Investments, Banks, etc.*, 1937, at p. 1743. In the balance sheet of General Investment Corporation for May 1936, the Terminal Company notes were carried in the assets at \$8,641,823. However, on the liability side of the balance sheet, there was set up a general reserve of \$5,000,000 which is applicable, in view of the other items in the balance sheet, to the value of the notes. Accordingly, the actual net value fixed for the notes would be \$3,641,823.

<sup>540</sup> Op. cit. supra, note 534, at 15059, 20237.

<sup>541</sup> Mr. Billings was the representative of General Investment Corporation in the management of the Terminal Company. In 1932 and 1933 he was also a vice president of General Investment Corporation. (Public Examination, American General Corporation, et al., Commission's Exhibit No. X3424, p. 16.)

<sup>542</sup> Op. cit. supra, note 534, at 20236a, 20237-8.

<sup>543</sup> Instituto Mobilizador de Inversiones Bancarias was created under Argentine law to take over from the Banco de la Nacion Argentina, and other Argentine banks a number of frozen assets. The "Instituto" had the power to sell, liquidate, trade, put new money in, and to clear up frozen assets held by banks. (Id., at 15072.) At this time various Argentine banks held all of the common stock of the Terminal Company as collateral for loans to the La Croze family, the owners of such stock. The Terminal Company's common stock was apparently transferred to the "Instituto," which contemplated a reorganization of the capital structure of the Terminal Company as a means of creating a value for such stock. Apparently as part of the reorganization program it was decided to purchase the notes of the Terminal Company held by General Investment Corporation. (Ibid.)

had previously acquired control of other investment companies,<sup>544</sup> commenced negotiations to acquire control of General Investment Corporation from the American General Corporation. In May 1936, just after Mr. Billings had tentatively arranged to sell the railway for approximately \$7,500,000 subject to the approval of the management of General Investment Corporation, Mr. Warriner discussed with Philip De Ronde, with whom he had had no previous business dealings,<sup>545</sup> but who had been an associate of Wallace Groves,<sup>546</sup> whether he would undertake the completion of the sale of the Terminal Company's notes if and when he, Mr. Warriner, purchased control of General Investment Corporation.<sup>547</sup> The method whereby Ernest B. Warriner acquired control of General Investment Corporation will now be outlined.

Mr. Warriner had, in February 1936, acquired voting control of International Equities Corporation, an investment company of the general management type.<sup>548</sup> Prior thereto his principal activity in

<sup>544</sup> Ernest B. Warriner, who had known Wallace Groves "years before," met Mr. Groves again in 1931 and immediately became associated with him in the latter's activities in acquiring control of investment companies. Prior thereto Mr. Warriner had not been associated with any investment company. (Public Examination, The Equity Corporation, at 1829, 1834-40.) Mr. Warriner testified that he recommended the purchase of Interstate Equities Corporation to Wallace Groves. (Id., at 1832-3.) After Wallace Groves acquired control of Interstate Equities Corporation, Yosemite Holding Corporation, Chain & General Equities, Inc., Granger Trading Corporation, and Joint Investors, Inc., he designated Mr. Warriner as his nominee on the board of some of these companies. (See supra, pp. 181-226. *Investment Companies Acquired and Controlled by Wallace Groves.*) In November 1931, Mr. Groves paid Warriner \$15,000 commission for bringing to him the Interstate Equities Corporation transaction. In 1933, Groves paid Mr. Warriner "out of pocket expenses" of \$4,734.87.

After Wallace Groves sold his interest in The Equity Corporation to David Milton and others, Mr. Warriner continued to maintain his business association with Wallace Groves. (Public Examination, General Investment Corporation, at 20310.) Mr. Warriner not only continued to represent Mr. Groves in various transactions, but for a period of time he shared an office with Mr. Groves. (Id., at 20310.)

Subsequently, in 1935, when Mr. Warriner commenced to acquire control of investment companies, he occupied an office directly above that of Wallace Groves. (Id., at 20310-11.) The extent of their close association is further indicated by the fact that while Mr. Warriner was carrying on his negotiations for the acquisition of investment companies he had to assure those with whom he was negotiating that he was not associated with or acting for Wallace Groves. (See testimony of Wilfred S. Robinson, id., at 15146-7; Harlan J. Wright, id., at 20625; Harold S. Maddock, id., at 20577; Wallace Groves, id., at 20589; R. S. Elliott, id., at 15162; Ray Morris, id., at 15251; Walter S. Mack, id., at 15274-9; Ernest F. Henderson, id., at 15334-5, 15339.)

<sup>545</sup> Id., at 15068.

<sup>546</sup> Philip De Ronde, who at one time had been president of the Hibernia Trust Company, had long been a close business associate of Wallace Groves. As a member of the Prince & Whitely Creditors Corporation which had been selected to liquidate and manage the assets of the Prince & Whitely, the brokerage firm, which sponsored and controlled Phoenix Securities Corporation, he aided Wallace Groves in 1933 in acquiring control of that company. (Id., at 15067, 20210-3.) Wallace Groves paid him \$25,000 for his services in this connection. (Id., at 20213-5.) Subsequent to Mr. Groves' acquiring control of Phoenix Securities Corporation, he designated Mr. De Ronde as a member of the board of directors of Phoenix Securities Corporation, which position he still held at the time of the Commission's Public Examination on May 8, 1938. (Id., at 15068.)

<sup>547</sup> The exact dates on which these discussions took place are not certain. However, Mr. De Ronde, who testified before the Securities and Exchange Commission on May 8, 1938, with respect to this transaction, indicated that this conversation took place "at least a year or a year and a half ago," which fixes the date at some time in May 1936, prior to the acquisition of control of General Investment Corporation by Mr. Warriner. (Id., at 15069.) De Ronde had never had, prior to this conversation, any business association with Ernest B. Warriner. (Id., at 15068.)

<sup>548</sup> See infra, notes 550, 552.



connection with investment companies had consisted of his association with Wallace Groves while the latter was acquiring control of various investment companies.<sup>549</sup> Although Wallace Groves denied that Mr. Warriner was his agent or "dummy" in the transaction whereby Mr. Warriner acquired control of International Equities Corporation, and although Mr. Groves denied that he had any influence or control over Ernest B. Warriner or International Equities Corporation after Mr. Warriner acquired control of that investment company, the fact is that Wallace Groves and his brother, George Groves, had supplied Mr. Warriner with almost all of the funds<sup>550</sup> with which the latter acquired his large block of stock of International Equities Corporation in November 1935. Thereafter, by the use of tactics similar to those which had been used by Wallace Groves when he acquired control of various investment companies,<sup>551</sup> Mr. Warriner had succeeded, by February 1936, in acquiring control of International Equities Corporation by the use of that company's own funds.<sup>552</sup>

<sup>549</sup> See note 544, *supra*.

<sup>550</sup> On November 5, 1935, Ernest B. Warriner purchased 11,049 shares of the Class A and 4,586 shares of Class B stock of International Equities Corporation, representing 23% of the voting power of that corporation, for \$185,070.75. (Id., Commission's Exhibit No. 1577.) To consummate this purchase he borrowed \$50,000 from Underwritings and Participations, Inc., an investment company which he controlled (*ibid.*) and \$139,000 from the Delaware Trading Corporation (id., at 20229), on the security of the International Equities Corporation stock, which he had purchased. (Id., at 20230, 20232-3.) The Delaware Trading Corporation was a personal holding company of Wallace Groves and George Groves, his brother. (Id., at 20229, 20460.) Wallace Groves was not directly connected with this company at the time it lent the \$139,000 to Mr. Warriner, having previously transferred his interest therein to George Groves. (Id., at 20229.) However, at the time when this loan was made by the Delaware Trading Corporation to Mr. Warriner, Wallace Groves was making substantial loans to Delaware Trading Corporation and his brother, George Groves. (Id., at 20466.) Wallace Groves conceded that he may have had a "pecuniary interest" in the International Equities Corporation stock hypothecated with the Delaware Trading Corporation. (Id., at 20466.) Subsequently, in January, after Mr. Warriner had succeeded in acquiring control of International Equities Corporation and General Investment Corporation, Mr. Wallace Groves reacquired his stock interest in Delaware Trading Corporation from his brother, George Groves, in satisfaction of a loan. (Id., at 20229-30, 20462, 20466.)

<sup>551</sup> See *supra*, pp. 181-226, *Investment Companies Acquired and Controlled by Wallace Groves*. Mr. Groves' method was to contract personally to acquire controlling block of stock of investment companies and in substance compel other investment companies under his control to purchase these controlling blocks from him at a profit to himself so that only a comparatively nominal amount of his personal funds were used to acquire control of investment companies.

<sup>552</sup> On February 21, 1936, Mr. Warriner contracted to purchase from Louis J. Kolb and his associates in control of International Equities Corporation, 9,211 shares of its Class A stock and 5,189 shares of its Class B stock. Louis J. Kolb received Mr. Warriner's promissory note payable six months from the date of the agreement as payment for the shares. (Id., Commission's Exhibit No. 1577.) The shares of stock which were the subject of this agreement and which increased Mr. Warriner's control to 56% of the "A" stock and 50% of the "B" stock of International Equities Corporation, were escrowed with the National City Bank, subject to the payment of Mr. Warriner's promissory note, but he was permitted immediately to vote the stock. Mr. Warriner had himself and his associates elected to the board of directors of International Equities Corporation. Thereafter, on August 21, 1936, Mr. Warriner caused International Equities Corporation to assume his obligation of \$266,977 on his promissory note due to Louis J. Kolb, and acquire the International Equities stock which Mr. Warriner had agreed to purchase. In the meantime, on July 28, 1936, Mr. Warriner caused International Equities Corporation to purchase from Consolidated Funds Corporation 6,192 shares of the Class A stock and 6,310 shares of the Class B stock for \$174,960.80. (Id., at 15128-33 and Commission's Exhibit No. 1567.) The effect of this reduction of the outstanding stock of International Equities Corporation was to increase the voting power of the shares held by Mr. Warriner to 65% of its "A" stock and 71% of its "B" stock.



Immediately after Mr. Warriner had acquired control of International Equities Corporation, which then had assets of approximately \$1,165,000,<sup>553</sup> he directed his attention to the acquisition of control of General Investment Corporation, which had assets carried at about \$5,444,562 and evidently worth approximately \$9,300,000.<sup>554</sup> In July 1936 Mr. Warriner completed negotiations to purchase the stockholdings of American General Corporation in General Investment Corporation<sup>555</sup> for \$1,110,000, of which \$300,000 was to be paid immediately and the balance was to be paid in installments over a period of four years.<sup>556</sup>

However, Mr. Warriner personally did not purchase these blocks of General Investment Corporation stock. On August 3, 1936, Mr. Warriner caused International Equities Corporation, which he controlled, to purchase American General Corporation's controlling interest in General Investment Corporation,<sup>557</sup> and to make the down payment of \$300,000 on the contract. Thus Mr. Warriner acquired indirect control of General Investment Corporation through International Equities Corporation without the expenditure of any of his personal funds. Although the stock of General Investment Corporation was to be held as collateral by American General Corporation until completion of the purchase payments, Mr. Warriner was given the power immediately to vote the stock.<sup>558</sup> All of the representatives of American General Corporation on the directorate of General Investment Corporation resigned, and Mr. Warriner had himself and his associates elected as officers and directors of General Investment Corporation.<sup>559</sup>

<sup>553</sup> *Moody's Manual of Investments, Banks, etc.*, 1937, at p. 1741.

<sup>554</sup> In addition to cash and securities worth \$1,802,739 (see note 539, *supra*), General Investment Corporation had by this time received a tentative offer of \$7,500,000 for the Terminal Company notes.

<sup>555</sup> *Op. cit. supra*, note 534, Commission's Exhibit No. 1577.

<sup>556</sup> *Id.*, Commission's Exhibit No. 1565. The Class A common stock and the common stock of General Investment Corporation which Warriner had agreed to purchase had no asset value. The 13,690 shares of the \$6 preferred stock of General Investment Corporation held by American General Corporation had a liquidating value of approximately \$1,010,185 (*Moody's Manual of Investments, Banks, etc.*, 1937, at p. 1743), based on an agreed minimum value of \$2,850,000 for the Terminal Company notes in the contract of sale. On this basis American General Corporation received \$89,815 in excess of the liquidating value of the General Investment Corporation's preferred stock. However, on the basis of the \$7,500,000 tentative offer for the Terminal Company's notes, the price paid to American General Corporation was substantially less than the liquidating value of the preferred and common stock of General Investment Corporation. The contract provided that American General Corporation was to receive 11% of the proceeds of any sale of the Terminal Company notes in excess of \$2,850,000. (*Op. cit. supra*, note 533, Commission's Exhibit No. 1565.)

<sup>557</sup> *Op. cit. supra*, note 534, Commission's Exhibit No. 1565.

<sup>558</sup> *Ibid.*

<sup>559</sup> Wilfred S. Robinson became a vice president and director, Gertrude S. Holman the secretary, and Ernest B. Warriner president of General Investment Corporation. H. S. Maddock, E. B. Warriner, B. C. Milner, Jr., and Ellis A. Baker became directors of the company. (*Id.*, Commission's Exhibit No. 1567.) Messrs. Maddock, Milner, Baker, and Robinson were acquaintances of Ernest B. Warriner. (*Id.*, at 15140-1.)

Gertrude Holman, who was Mr. Warriner's secretary from November 1935 to March 1937, during the period when Mr. Warriner was affiliated with International Equities Corporation and General Investment Corporation, was formerly associated with Wallace Groves and George Groves, his brother. Her first association with Wallace Groves appears to have been in 1929 when she was employed by him as a secretary in Baltimore. (*Id.*, at 15037.) Her next position was with Franklin Management Corporation in Philadelphia, which was a George Groves company (*id.*, at 15035-6), and then next with the Domestic

Although American General Corporation (which was controlled by The Equity Corporation) dominated General Investment Corporation through its ownership of all that corporation's Class A common stock, its total investment in General Investment Corporation represented only a 22% interest in its assets. The public holders of the securities of General Investment Corporation would have been entitled to 78% of the assets of the corporation had the investment company been then dissolved.

Despite the fact that the public held the predominant ownership interest in the assets of General Investment Corporation, The Equity Corporation and American General Corporation did not inform the public holders of the securities of General Investment Corporation of their intention to transfer control of the latter investment company to Ernest B. Warriner. Moreover, the officers of The Equity Corporation, who were "conscious of a duty that they owed the \* \* \* stockholders with respect to the individuals to whom they were going to turn over this trust" were also aware of Mr. Warriner's prior association with Wallace Groves. In fact, R. S. Elliott, secretary of The Equity Corporation, testified that the officers of The Equity Corporation asked Mr. Warriner if he was representing Mr. Groves in the transaction to acquire control of General Investment Corporation.<sup>560</sup> Mr. Warriner, however, informed the officials of The Equity Corporation that he was purchasing control of General Investment Corporation on his own behalf and on behalf of International Equities Corporation. In this connection, R. S. Elliott testified:<sup>561</sup>

Q. Now, \* \* \* Mr. Elliott, although The Equity Corporation interests were not associated with General Investment Corporation during the period when it sustained a substantial shrinkage in capital, the fact of the matter was that there was a time when the Equity interests had a substantial interest in General Investment Corporation, isn't that so?

A. Yes: that is true.

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Finance Corporation in Chicago, a company in which Wallace Groves had an interest. (Id., at 15035.) Her next position was with Hunter Distillery in Baltimore, a Wallace Groves owned company. (Id., at 15034-5.) Wallace Groves then got her a position with Mr. Warriner, having introduced her to him on the first day of her employment. She was secretary to Mr. Warriner from November 12, 1935 (id., at 15036), the time when Mr. Warriner first acquired his interest in International Equities Corporation, to March 15, 1937, when Mr. Warriner sold control of International Equities corporation to the Henderson Bros. of Boston. (See *infra*, pp. 615-16.) She was nominated by Mr. Warriner as a director of International Equities Corporation and General Investment Corporation. (Id., at 15037-8.) She was secretary and treasurer of General Investment Corporation from November 30, 1936, until March 15, 1937.

<sup>560</sup> David M. Milton and Ellery C. Huntington, the largest stockholders in The Equity Corporation, had in 1933 purchased control of that company from Mr. Groves and presumably therefore were familiar with his previous activities in connection with investment companies. It is to be noted that negotiations for the sale of General Investment Corporation to Mr. Warriner by American General Corporation occurred at about the time that the activities of Mr. Groves and Mr. Warriner in the acquisition of control of Yosemite Holding Corporation, Chain & General Equities, Inc., Interstate Equities Corporation, all of which became subsidiaries of The Equity Corporation in 1932, were, to the knowledge of the officers of The Equity Corporation and of American General Corporation, the subject of a public examination by this Commission. The activities of Mr. Groves and Mr. Warriner in connection with these companies are discussed in *supra*, pp. 181-226, *Investment Companies Acquired and Controlled by Wallace Groves*.

<sup>561</sup> Op. cit. *supra*, note 534, at 15162-5.

Q. And they were substantial minority stockholders, isn't that so?

A. Yes; I believe our asset position was about 22 percent of the assets of General Investment Corporation, that is American General's, at the date of the sale and the stock vote was perhaps over 50 percent.

Q. So that Equity Corporation had voting control of the situation but the public had 80 percent of the money.

A. Yes.

Q. And this was a question of Equity Corporation turning over to somebody control of the General Investment Corporation, isn't that so?

A. Yes.

\* \* \* \* \*

Q. And I assume that you and the other members of the American General Corporation were conscious of a duty that they owed the minority stockholders with respect to the individuals to whom they were going to turn over this trust, isn't that so?

A. Yes; we felt that we should deal or should sell it to a responsible corporation, which was International Equities, and we looked into their balance sheet.

Q. Now you are talking, Mr. Elliott, about the financial condition of International Equities and, of course, the corporation as a legal entity or fiction—but the important thing was the personalities in International Equities, because ultimately they were the ones who were going to handle the General Investment Corporation funds; isn't that so?

A. That is right.

\* \* \* \* \*

Q. Did you ask him [Mr. Warriner] where he got the money to buy International Equities in the first instance?

A. No; I did not.

Mr. Elliott testified further:<sup>562</sup>

Q. Had you known Mr. Warriner before that?

A. I had met Mr. Warriner in previous years. I think in late 1932 and early 1933, and I hadn't seen him since.

Q. And that time he was on the board of directors of Yosemite Holding Corporation, Chain & General Equities, Inc., and Interstate Equities Corporation?<sup>563</sup>

A. Yes; I believe he was on several of those boards.

Q. While those corporations were in control of Mr. Wallace Groves; isn't that so?

A. That is true.

Q. And you knew that he was closely associated with Mr. Wallace Groves.

A. We asked Mr. Warriner if Mr. Groves was interested in this, and Mr. Warriner said that he was not.

Q. Well, do you remember what prompted you to ask the question whether Mr. Wallace Groves was interested?

A. Well, it may have been brought out by the hearings that were held about that time down here, which you were conducting. Mr. Schenker, and you brought out the fact that Mr. Warriner had been associated with Mr. Groves in 1932.

Q. And was there any significance to the fact that he was or was not associated with Mr. Groves?

<sup>562</sup> Id., at 15161-2.

<sup>563</sup> These companies late in 1932 became subsidiaries of The Equity Corporation under the control of Wallace Groves, who in 1933 transferred control of The Equity Corporation and of these companies to the present management of The Equity Corporation. See *supra*, pp. 181-226, *Investment Companies Acquired and Controlled by Wallace Groves*.

A. Well, we wished to inquire as to whether he was, and he said that he was not.

Q. Suppose the answer had been "yes."

A. Well, that might have made a different complexion, and we might have thought that we were dealing with Mr. Groves but we did not; we thought that we were dealing with Mr. Warriner and with International Equities. We looked at their balance sheet.<sup>564</sup>

Although Mr. Elliott testified that the management of The Equity Corporation and of American General Corporation relied only on the financial responsibility of International Equities Corporation, to whom they sold control of General Investment Corporation, the fact is that the assets of International Equities Corporation then had a total value of \$1,165,000, as compared with the price of \$1,100,000 which it had contracted to pay to American General Corporation for control of General Investment Corporation. These facts suggested to Frederick S. Burroughs,<sup>565</sup> the former president of General Investment Corporation, that it may have been the intention of International Equities Corporation to meet its obligation to American General Corporation at least in part by the use of the assets of General Investment Corporation. Mr. Burroughs testified:<sup>566</sup>

Q. Now, you say you were suspicious of what might transpire. Was that because of the personalities that got control of the General Investment Corporation?

A. No: I knew nothing of the personalities. I had not heard of Mr. Warriner. I had heard of Mr. Groves, but I knew nothing of him personally; but the com-

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<sup>564</sup> In July 1937, American General Corporation commenced an action in the Chancery Court of Delaware for New Castle County to rescind its sale of General Investment Corporation to International Equities Corporation on the ground that Mr. Warriner fraudulently represented that he was acting in his own behalf in this purchase of control of General Investment Corporation while in truth he had actually acted in the transaction as the agent of Mr. Groves. On June 29, 1939, Chancellor W. W. Harrington, of the Chancery Court of Delaware, entered a decree of rescission canceling the sale of stock of General Investment Corporation by the American General Corporation to International Equities Corporation. The decree was granted with the consent of both parties in the action brought by American General Corporation against International Equities Corporation. As a result of this decree American General Corporation received from International Equities Corporation the following stock of General Investment Corporation: 13,690 shares of \$6 dividend preferred stock of 46.5% of the total issue; 97,487 shares of Class A stock or 97.5% of the total issue; 277,645 shares of common stock or 29% of the total issue, and warrants to buy 303,379 common shares.

In addition, pursuant to the decree, American General Corporation will pay to International Equities Corporation \$1,210,000, the amount originally paid by International Equities Corporation to American General Corporation. American General Corporation will pay \$950,000 to Standard Investing Corporation, controlled by the Henderson Bros. (see *infra*, pp. 614-5) \$950,000 for 126,000 shares of the common stock of Utility Equities Corporation and for the following stock of General Investment Corporation owned by Standard Investing Corporation: 4,741 preferred shares, 159,210 common shares and warrants to buy 3,005 common shares.

In the settlement, the General Investment Corporation is to receive from International Equities Corporation \$1,050,000 in cash for certain real estate securities which are to be bought from General Investment Corporation by International Equities Corporation.

With the 151,700 shares of Utility Equities Corporation stock owned by General Investment Corporation and the 126,000 shares owned directly, American General Corporation will have an interest of 49% in the common stock of Utility Equities Corporation, whose assets, as at March 31, 1939, were \$6,720,686. (*The New York Times*, June 30, 1939.)

<sup>565</sup> Subsequently Mr. Burroughs, as a stockholder of General Investment Corporation, brought a suit against Mr. Warriner and Mr. Groves for their alleged mismanagement of the assets of General investment Corporation. See notes 590 and 619, *infra*.

<sup>566</sup> *Op. cit. supra*, note 534, at 15220-1.

pany that bought the General Investment Corporation had a little more than a million dollars in assets, and they had contracted to buy something more than a million of the Founders interests over a period of time; and it seemed to me they were probably calculating on taking that million dollars one way or another out of the General Investment Corporation.

Q. That was the usual technique of buying control, which was to borrow money and use the corporation's money to pay the loan?

A. That is not usual, but it may happen.

Q. That was the thing you were afraid of in this situation if the International Equities got control of General Investment Corporation?

A. I didn't see any other way they could pay their debt, and I was afraid that was what they were planning to do.

Subsequently, as will be seen, the assets of General Investment Corporation were used in part to enable International Equities Corporation to meet its obligation to American General Corporation under the terms of the contract by which International Equities Corporation acquired control of General Investment Corporation.

## 2. MANAGEMENT POLICIES OF ERNEST B. WARRINER

### a. Sale of Buenos Aires Central Railroad & Terminal Company Notes

For the purposes of the contract providing for sale of General Investment Corporation by American General Corporation to International Equities Corporation, the investment in the Buenos Aires Central Railroad & Terminal Company had been valued at only \$2,850,000.<sup>567</sup> Mr. Billings, however, as previously stated, had tentatively arranged for the sale to the Instituto Mobilizador Inversiones de Bancarias of the Terminal Company's investment for approximately \$7,500,000. Mr. Warriner had acquired control of General Investment Corporation while Mr. Billings was returning from Buenos Aires to discuss these terms with the management of General Investment Corporation. Mr. Billings discussed his negotiations for the sale of the Terminal Company notes with Mr. Warriner and Philip De Ronde, with whom Mr. Warriner had, as has already been stated, even prior to his purchase of General Investment Corporation, discussed the sale of the Terminal Company investment.<sup>568</sup> Thereafter, on August 26, 1936, Mr. De Ronde returned with Mr. Billings to Buenos Aires to consummate the sale of the Terminal Company notes. According to the testimony of Mr. Billings, Mr. De Ronde was merely to determine whether Mr. Billings was capable of completing the negotiations for the sale of the Terminal Company's notes and whether the terms upon which he had agreed to sell the investment were the best available terms.<sup>569</sup> In fact, on August 27, 1936, General Investment Corporation agreed to pay Mr. Billings \$50,000 if he succeeded in selling the Terminal Company's notes to

<sup>567</sup> Id., at 20243-4. The contract, however, did contain the provision that if the railway were sold for a sum in excess of this amount that the American General Corporation was to receive 11% of the difference. (Id., Commission's Exhibit No. 1565.)

<sup>568</sup> See note 546, *supra*. Mr. Warriner had immediately upon acquiring control of General Investment Corporation cabled to Mr. De Ronde to return from China. (Id., at 15069-70, 15075.)

<sup>569</sup> Id., at 15074, 20240.

the "Instituto,"<sup>570</sup> whereas no contract, however, was made between Mr. De Ronde and General Investment Corporation with respect to his services or the amount of commissions, if any, to be paid to him. Nor was the board of directors of General Investment Corporation requested to approve the selection of Mr. De Ronde to negotiate the sale of the Terminal Company notes. Mr. De Ronde testified:<sup>571</sup>

Q. You were on your way to South America without any agreement in writing?

A. That is right.

Q. Without a memorandum or even a piece of paper showing that you were hired?

A. That is right.

Q. There wasn't a note or memorandum even relating to the agreement you say you had relative to the expenses?

A. That is correct.

Q. Did you ask Mr. Warriner to request the board of directors to pass a resolution to authorize the hiring of Mr. De Ronde to negotiate in South America?

A. No, sir.

Q. Do you know whether when you started to South America the board of directors authorized your retention as negotiant in South America?

A. It never occurred to me to inquire.

\* \* \* \* \*

Q. And you say it never occurred to you whether the board of directors authorized your hiring as negotiant on a deal which might involve \$7,000,000?

A. That is correct.

Q. And you never had a piece of paper setting forth the terms of your compensation?

A. That is right.

Q. Did you meet any other members of the board of directors of the General Investment Corporation?

A. I can't say I knew who they were.

Q. The only thing you got a wire in China, came on to New York and you talked to Mr. Warriner and he said "Go on down and we will pay your expenses if you are not successful and we will pay what we think it is worth if you consummate the deal," is that right?

A. Roughly.

Only Wallace Groves concurred in the selection of Mr. De Ronde as the person capable of selling the Terminal Company notes for General Investment Corporation.<sup>572</sup> Thereafter, Wallace Groves evi-

<sup>570</sup> Id., Commission's Exhibit No. 3175. On December 11, 1936, the original contract was superseded by an agreement to pay Mr. Billings a flat sum of \$35,000 as his commission, plus an additional \$15,000 contingent upon the receipt by General Investment Corporation of the current interest due on its holdings of the notes of the Terminal Company. (Ibid.)

<sup>571</sup> Id., at 15074-5.

<sup>572</sup> Mr. Wallace Groves testified as follows (id., at 20236) :

Q. And you say that Mr. Warriner did not talk to you and ask whether Mr. De Ronde would be the person to be sent down to South America to see if he could close the subway deal?

A. \* \* \* I do not know that I did. I was up at Rainy Lake, Minnesota, and De Ronde was in China, I believe, some place in the Orient. I do not know, or in South America. That was about the time that Warriner got control of General Investment from American General, and he told me something about the deal, and he told me of his contract, and he told me he thought De Ronde, having lived in South America and in the Argentine for a number of years, and speaking the language, and so forth, would be a fine fellow to negotiate for it. I said that sounded sensible, "we ought to have somebody that knows the people, that speaks the language, that lives with them." That sounded reasonable \* \* \*.

denced a continuing interest in the progress of the negotiations for the sale of the Terminal Company notes. Mr. Groves as well as Mr. Warriner was consulted by Mr. De Ronde by telephone from Buenos Aires.<sup>573</sup>

Mr. De Ronde, who, in the meantime, had displaced Mr. Billings in the negotiations,<sup>574</sup> sold the Terminal Company's notes to the "Instituto" on November 27, 1936. The sales price was substantially the same as the offer made to Mr. Billings by the "Instituto" in August of 1936.<sup>575</sup> General Investment Corporation received as a result of the sale of these notes \$5,750,000 in cash and a \$1,750,000 participation in a debenture issue of the reorganized Buenos Aires Central Railroad & Terminal Company.<sup>576</sup>

#### b. Disposition of Proceeds of Sale of the Notes of Buenos Aires Central Railroad & Terminal Company

Within a period of approximately two months after the sale of Terminal Company notes, the bulk of the \$5,750,000 in cash, so derived by General Investment Corporation, was expended in transactions in which Wallace Groves or his associates were pecuniarily interested.<sup>577</sup>

<sup>573</sup> Mr. Billings testified (*id.*, at 20272-3) :

A. \* \* \* De Ronde was talking to Warriner in connection with the transaction, and at the same time was speaking to Wallace. Now, he did not say Groves, but he did say Wallace. Subsequent to the termination of these conversations, De Ronde exacted my word from me that I would not reveal to any person the fact that he had been in conversation, or that Wallace had been in conversation with him in Buenos Aires—

Q. Did he tell you why he did not want anybody to know that he had spoken to Wallace?

A. Well, he told me because of some conditions surrounding the trade by which Warriner became president of General Investment Corporation, and it was definitely agreed that Wallace Groves was not any party to the General Investment Corporation.

<sup>574</sup> Mr. Billings returned to New York leaving the completion of the sale to Mr. De Ronde, who, as has been stated, had been sent to Buenos Aires with the approval not of the directors of General Investment Corporation but of only Messrs. Warriner and Groves. (*Id.*, at 20256-8.)

<sup>575</sup> *Id.*, at 15078.

<sup>576</sup> *Id.*, at 15078-9. The annual report for General Investment Corporation as at May 31, 1937, shows that General Investment Corporation received \$5,698,269 in cash and \$1,734,750 as a subparticipation in the syndicate loan.

<sup>577</sup> During the interim when Wallace Groves was interested in having General Investment Corporation make investments in transactions in which he was personally interested, the Groves interest made an advance of \$25,000 to Mr. Warriner to enable him to meet an installment due on his contract to purchase control of General Investment Corporation. Gertrude Holman, secretary of General Investment Corporation, testified (*id.*, at 20278-9, 20285) :

Q. In any event, there was a payment due and International Equities did not have the cash to pay for it?

A. That is right.

Q. So they borrowed the money from somebody?

A. Yes, sir.

Q. You say you assumed it was Wallace Groves?

A. I did, because Mr. Wallace Groves brought me the check.

Q. What?

A. Mr. Wallace Groves brought me the check in the amount of \$25,000.

Q. Do you recall whose check it was?

A. I think it was a bank cashier's check, but I am not certain.

\* \* \* \* \*

Q. Do you recall at the present time whether there was any entry made in any book with respect to that borrowing of \$25,000?

A. The only notation I made was on the stub of the check book when the check was deposited.

Q. Saying what?

A. Saying the deposit of \$25,000 was made, and the date.

Q. And from whom it was received?

A. I did not enter that.

Q. Or for what purpose it was received?



## (1) COMMISSION OF \$435,000 PAID TO PHILIP DE RONDE AND OTHERS

Of the \$5,750,000 received in cash on the sale of the Terminal Company notes, General Investment Corporation was caused to pay \$435,000 as "commissions" in connection with the sale of these notes. Mr. Billings was paid \$35,000,<sup>578</sup> and the balance of \$400,000 was paid to Mr. De Ronde and others.

Mr. De Ronde, immediately after the sale of the Terminal Company note, had requested General Investment Corporation to pay \$150,000 to a banking syndicate which he testified was essential to finance the "Instituto" in effecting the purchase of the Terminal Company's notes.<sup>579</sup> However, the "banking syndicate," comprised of Bracht & Company and Bemberg & Company of Buenos Aires, denied that they ever kept this \$150,000. Philip De Ronde denied that he received any part of the \$150,000 in commissions paid to these bankers. He testified:<sup>580</sup>

Q. \* \* \* And then you say there was a payment of \$150,000 to somebody. Whom was that paid to?

A. That was paid to an organization of the syndicate, the banking house.

Q. Who were the banking houses?

A. The two that headed the syndicate were Bracht and Co. and Bemberg and Company although the latter firm operated under a corporate name.

A. No, sir.

Mr. Groves did not deny that this advance was made. He testified (id., at 20289):

Q. Did you give your check for \$25,000?

A. I do not recall. I am sure if Miss Holman said I did, I must have \* \* \*.

\* \* \* \* \*

A. \* \* \* Warriner came to either George Groves or myself and said that they had some securities they could sell but they did not want to sell them because the previous management had acquired them a long time ago and if they sold them they could not deduct a tax loss on them the following year, and he needed a small sum of money over the end of the year period, or something like that, and apparently the \$25,000 was advanced by George Groves. It was not advanced by me \* \* \*.

Subsequently in January 1937 the \$25,000 was repaid to Wallace Groves in the form of cash. Miss Holman testified (id., at 20277-8, 20280, 20287-8):

Q. Will you tell us who asked you to draw it, whether you were told for what purpose it was drawn, and whom it was drawn for, please?

A. It was to repay a loan made to International Equities Corporation. Mr. Warriner asked me to have the check cashed at the First National Bank of Jersey City.

\* \* \* \* \*

Q. The International Equities Corporation owed the money?

A. Yes.

Q. And it owed it to whom?

A. I assumed it was Mr. Wallace Groves.

\* \* \* \* \*

Q. In any event, you saw the \$25,000 of the corporation's money being drawn in cash and you were being told it was being paid to Mr. Groves, you assumed, to pay off an obligation of International Equities Corporation to Wallace Groves, is that not so?

A. I assumed the obligation was with Mr. Wallace Groves.

Q. Did you ask for a receipt of Mr. Wallace Groves when he got the \$25,000?

A. I did not.

Q. Did you ask Mr. Warriner to make sure that he got a piece of paper from Mr. Groves that he got this \$25,000?

A. No, sir; but there may be a letter in the file to that effect.

Q. From whom?

A. I think it should be signed by Mr. Groves, but I am not certain.

\* \* \* \* \*

Mr. SCHENKER. Mr. Groves, do you remember any such letter?  
Mr. GROVES. No.

<sup>578</sup> Id., at 20261 and Commission's Exhibit No. 3175.

<sup>579</sup> Id., at 15079. The only payment by Mr. De Ronde of which Mr. Billings knew was \$3,500 which was due to a Paraguayan who participated in the negotiations. (Id., at 20253.)

<sup>580</sup> Id., at 15079-80.



Q. How was the \$150,000 paid, do you remember?

A. Yes, sir; it was remitted directly by the General Investment Corporation by cable to either or both of these banking firms.

Q. And how was the money divided?

A. I have no idea, sir.

Q. Did you get any part of that money?

A. No part of that money.

Q. So that \$150,000 went as a banking commission?

A. We call it an overriding commission or banking commission or initiators' commission or finding commission.

Q. Now General Investment Corporation was a participant in that banking syndicate?

A. That is correct.

Q. Did you get any part of that \$150,000 back?

A. No, sir.

Q. Did you make an effort to get any part of that money back for them?

A. None at all, sir.

Q. They had a 25% participation so if the overriding commission was \$150,000, they were entitled to \$40,000 of that money?

A. No, sir; not in the way the deal was set up \* \* \*.

According to the testimony of Mr. Billings, the bankers informed him that they turned the \$150,000 over to Philip De Ronde.<sup>581</sup>

In addition, General Investment Corporation was caused to pay \$250,000 as a commission to Mr. De Ronde himself.<sup>582</sup> A commission in this amount was paid, notwithstanding the fact that this sum substantially exceeded the commission of \$50,000 which the corporation had once agreed to pay Mr. Billings if he succeeded in effecting the sale on even better terms than had been obtained by Mr. De Ronde and notwithstanding the fact that there was no previous arrangement made as to the amount of commission to be paid to Mr. De Ronde. Mr. De Ronde testified:<sup>583</sup>

Q. You saw Mr. Warriner and what did you say to him?

A. The most important of what I said was "now then this job is over to the satisfaction of all concerned. What is my compensation to be? How are we going to agree on figures?" He said, "You name it and we will see," and I named it and he agreed.

Q. So you named a figure and Mr. Warriner said, "That is all right," and that figure was paid?

A. Correct.

Q. How much did you name?

A. \$250,000.

Q. Whereupon, I presume, Mr. Warriner sat down and drew you a check for the sum of \$250,000?

A. Oh, no; there was much more to it than that.

Q. There was much more to it than that?

A. It wasn't as simple as that.

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<sup>581</sup> Id., at 20250-1. Bemberg & Company and Bracht & Company refused to disclose to Mr. Billings what disposition, if any, Mr. De Ronde made of this \$150,000. (Ibid.)

<sup>582</sup> Id., at 20535.

<sup>583</sup> Id., at 15082-3.

Q. I was trying to get what appears to my mind to be natural sequence. You said, "I want \$250,000." Mr. Warriner said, "I will pay you \$250,000." Whereupon he reached for the check book of the General Investment Corporation and wrote you a check for \$250,000, did he?

A. No.

Q. What happened?

A. I asked for a check for \$100,000 and currency of \$150,000.

Q. Mr. Warriner was not paying you his own money?

A. Certainly.

Q. That money belonged to the stockholders of General Investment Corporation?

A. So far as I know.

Q. Did you ask for these bills in thousand-dollar bills?

A. No, sir; I didn't make any reference to the denominations.

Q. Was it given to you in thousand-dollar bills?

A. I don't recall the denominations.

Q. But \$150,000 was given in cash?

A. Yes, sir.

Q. And \$100,000 by check?

A. Yes, sir.

In accordance with Mr. De Ronde's specific request, \$100,000 was paid to him on January 6, 1937, by General Investment Corporation in the form of a check made payable to Philip De Ronde, Limited. Mr. De Ronde testified:<sup>584</sup>

Q. Now, how was the check to be drawn in the first instance; in whose name?

A. My corporation.

Q. What is the name of the corporation?

A. Philip De Ronde, Ltd.

Q. Where was that organization?

A. In Nassau.

Q. Are you an officer of the corporation?

A. I am.

Q. Are you a director?

A. Yes, sir.

Q. Are you a stockholder?

A. No.

Q. So in this corporation which bears your name, you are just an officer and director and don't own a single share of stock of that corporation?

A. Correct.

Q. The check for \$100,000; what did you do with that?

A. Took it to Buenos Aires.

Q. And deposited where?

A. In Buenos Aires in corporate name. I delivered it to the corporation.

The balance of the \$150,000 was paid to him in cash.<sup>585</sup> Mr. De Ronde testified that the entire \$250,000 was taken back by him to Buenos Aires and deposited there to the account of Philip De Ronde,

<sup>584</sup> Id., at 15083-4.

<sup>585</sup> Id., at 20276-7; 15101-6.

Limited,<sup>586</sup> but he refused to reveal the names of those other than himself who were interested in Philip De Ronde, Limited.<sup>587</sup>

Mr. De Ronde testified:<sup>588</sup>

Q. What did you do with the \$150,000 in cash?

A. I delivered that also to the corporation.

Q. Did you deposit it in the bank?

A. Sir, I can only say I delivered it to the corporation, which is a corporation.

Q. I understand that, but I have not only legal difficulties, but natural difficulties; I can't visualize you walking up to Philip De Ronde, Ltd., and handing the money to Philip De Ronde, Ltd. You turned that money over to somebody.

A. I turned it over to the corporation who disposed of it in various manners.

Q. By that you mean you put it in the corporation's bank account?

A. No; I don't mean that. I put it in the technical possession of the corporation.

Q. What do you mean by technical?

A. The legal possession.

Q. Did you turn it over to some individual?

A. I cannot go further than I have, sir, than to repeat I put it in the legal financial and proper possession of the corporation.

\* \* \* \* \*

Q. As far as the payment of \$250,000 was concerned, you carried on all the negotiations?

A. That is right.

Q. You were the one hired by Mr. Warriner?

A. That is right.

Q. You were the one that did the work and you were the one entitled to the compensation; is that so?

A. My corporation was.

<sup>586</sup> Id., at 15084, 15093.

<sup>587</sup> Philip De Ronde, Ltd., according to Mr. De Ronde, was incorporated in Nassau (id., at 15084) in October 1936 (id., at 15092) during the period when he was negotiating for the sale of the Terminal Company notes. Mr. De Ronde testified that he was a director and the president of, but not a stockholder of this company. (Id., at 15084.) Although ordered to do so by the Commission, he refused to give any further information with respect to the company or the persons interested in the company, or who specifically received the commission paid by General Investment Corporation to the company. (Id., at 20274.) Mr. De Ronde testified (id., at 15121, 15410):

Q. You say that you were president, who was treasurer?

A. Certain of these gentlemen associates of mine.

Q. Who was secretary?

A. Also.

Q. Who were the directors?

A. The Board of Directors with my sole exception, consisted of Argentineans, Paraguayans, and one Englishman.

By Commissioner HEALY:

You are directed to give the names of these officers.

The WITNESS. Sorry sir, I must respectfully decline to bring into these proceedings the names of honorable and outstanding business associates of mine in the Argentine.

Commissioner HEALY. That means that you decline to obey the direction to answer these questions?

The WITNESS. If it comes to that, sir, I would like the advice of counsel.

Commissioner HEALY. How much time you want to consult counsel?

The WITNESS. I don't know, sir, until I can find mine.

Commissioner HEALY. We will take a recess and during the recess you can make up your mind as to how much time you want to take to consult counsel and when you come back you can tell me and we will take it under consideration.

The WITNESS. Yes, sir.

Mr. De Ronde never reappeared at the hearing, but left the country before the Commission could institute proceedings to compel him to testify.

<sup>588</sup> Id., at 15084-97.

Q. You did the work?

A. Yes, sir.

\* \* \* \* \*

Q. You are not a stockholder in Philip De Ronde, Ltd.?

A. I am not a stockholder.

Q. Who are the stockholders in Philip De Ronde, Ltd.?

A. They constitute a group of Argentineans, Paraguayans, and English friends of mine.

Q. What are their names?

A. That I must decline to give even if I knew at this time.

Q. Even if you knew it?

A. I don't recall the stockholders.

Q. Will you please tell us who the principal stockholders are?

A. You will forgive me if I say it is a foreign corporation.

Q. You will forgive me if I say to you there was turned over to you \$150,000 of the public's money and I am trying to ascertain whether it was turned over to you for the work you did or some other reason.

You don't mind giving an account of \$150,000 cash that was paid to you in connection with work you were supposed to have done for a corporation?

A. Oh, no.

\* \* \* \* \*

Q. \* \* \* Just give me the names of the individuals whom you remember are the principal stockholders of Philip De Ronde, Ltd.

A. Sir, that is information I do not think I am privileged to give. These gentlemen whose names you desire to know are all foreigners.

Q. I know they are foreigners, but they happen to have taken some American money and that is what I am interested in.

A. For services rendered in the Argentine Republic in part by them.

Q. That money was paid to you?

A. Yes, sir; for the account of the corporation.

Q. \* \* \* Up to the present time have you personally received one dollar of that money?

A. Not one dollar.

Q. So in connection with the transaction where you never were hired and you did all the work you were receiving \$150,000 in cash and \$100,000 in check and it was turned over to the corporation in which you have no stock interest?

A. No.

Q. You have no stock interest?

A. That is right.

Q. You had no arrangement to get any part of that money from them, the individuals whose names you refused to tell us; is that right?

A. I don't like the word refused. I don't think I am privileged to reveal the business, confidential business of foreigners, Argentineans and other foreign friends of mine.

Q. \* \* \* By that do you mean the nature of their business is such that you cannot tell us?

A. Well, that contains an implication.

Q. I intended that to contain an implication. Is that what you mean?

A. That is not what I mean.

Q. As I understand these people are engaged in honorable, legitimate business; is that so?

A. That is so.

Q. And you say they legitimately and honestly earned this \$150,000 which was turned over to somebody in cash?

A. That is right.

Q. And you will not give us the names; is that right?

A. That is correct.

\* \* \* \* \*

Q. Now, as soon as you got the cash, what did you do, leave the country?

A. In about a week or ten days.

Q. Did you take the cash with you?

A. Yes, sir.

Q. Where did you take it?

A. Buenos Aires.

Q. And you feel you are not privileged to tell us the name of the individuals to whom you turned over the money?

A. I turned it over to the corporation.

Commissioner HEALY. A corporation is not a person, it is an artificial person. If you turned it over to the corporation you delivered it to an individual?

The WITNESS. That is correct, as Mr. Schenker pointed out.

Commissioner HEALY. Who was the individual?

The WITNESS. But this corporation is a foreign corporation doing business exclusively abroad and doing business only with foreigners and contains no American money. I do not feel privileged to discuss it. I admit the receipt of this \$250,000 and I admit taking it out of the country and delivering it to the corporation.

Commissioner HEALY. But your answer is you delivered it to the corporation, and it seems to me that answer gives Mr. Schenker the privilege of asking you how you delivered it to the corporation. Now if you cannot name the individual to whom it was delivered it just casts a doubt over the whole question of delivery?

The WITNESS. Well, sir, I must continue to decline to bring into this picture the names of certain Argentinean, English, and Paraguayan gentlemen who are back of my corporation.

Commissioner HEALY. In what capacity did the corporation receive the money? Was it received by its president or treasurer or secretary?

The WITNESS. I am president of the corporation.

By Mr. SCHENKER:

Q. But the individual to whom you turned the money over, whose name you will not disclose, what was his connection with the corporation?

A. With all due respect, sir, you will forgive my insistence for not going further into that question.

Commissioner HEALY. Are there any Americans whose names had been mentioned as being connected with the General Investment Corporation, who received any of this money, directly or indirectly?

The WITNESS. No, sir.

\* \* \* \* \*

Commissioner HEALY. If I understand your testimony correctly, you received nothing whatever as compensation for the work you did?

The WITNESS. As yet I have received nothing.

Commissioner HEALY. Have you any arrangement under which you will receive it?

The WITNESS. Not as yet, but I might repeat in that connection this corporation has many, many other enterprises.

By Mr. SCHENKER:

Q. But this enterprise is consummated?

A. That is true.

Q. And this enterprise has been paid for?

A. That is so.

\* \* \* \* \*

By Mr. SCHENKER:

Q. Now, still proceeding on the assumption that you will not disclose the name of the person to whom the money was turned over, it was turned over to an individual, wasn't it?

A. Turned over to the corporation.

\* \* \* \* \*

Q. Did you walk into the board of directors room with nobody sitting there and drop \$150,000 on the table and walk out of the room?

A. You will forgive me, sir, if I again repeat that I delivered it into the possession of the corporation and beyond that I can go no further.

However, he did testify that no "Americans whose names have been mentioned as being connected with General Investment Corporation" had any interest in Philip De Ronde, Limited.<sup>589</sup> Mr. Groves testified that he personally did not retain any portion of the commission paid him.<sup>590</sup>

## (2) REPURCHASE OF \$6 PREFERRED STOCK AT PROFIT TO WALLACE GROVES

In addition to the \$435,000 of funds disbursed in the form of "commissions" in connection with the sale of the Terminal Company notes, General Investment Corporation expended \$2,500,000,

<sup>589</sup> Id., at 15094. However, on February 4, 1937, Ernest B. Warriner purchased from one E. Everett Baker, certain securities for \$11,000, paying therefor in eleven \$1,000 bills. (Id., Commission's Exhibit No. 3176.) And, according to the testimony of Wilfred S. Robinson, one of the directors of General Investment Corporation, Mr. Warriner's secretary had informed him that in January 1937 Mr. Warriner had repaid his indebtedness of \$139,000 to the Delaware Trading Corporation. (Id., at 20679.) However, Wallace Groves testified that the Delaware Trading Corporation was repaid the \$139,000 plus \$11,000 in interest in March 1937, at the time of the sale by Mr. Warriner of his control of International Equities Corporation to Henderson Brothers for \$2,000,000. (Id., at 20476-8.)

<sup>590</sup> Id., at 20220. Frederick S. Burroughs brought a stockholder's suit in the Chancery Court of New Jersey to compel, among other things, the repayment to General Investment Corporation of the \$150,000 in cash paid as commissions to Mr. De Ronde. In connection with this aspect of this suit, Mr. Burroughs testified (id., at 15222-3):

A. \* \* \* I made some allegation in the bill of complaint about that which I didn't believe was a proper commission, and demanded that that be undone and that at least \$150,000 be returned. I specified the \$150,000 in cash because on a review of the facts, I did not believe that Mr. De Ronde had ever received the \$150,000, but I had no way of proving it.

Q. What made you suspicious was that Mr. De Ronde didn't keep any of the \$150,000 in cash?

A. Well, I never heard of a transaction conducted in that way before, and it just didn't seem logical to me, but perhaps I had an unduly suspicious nature.

Q. You have heard of instances in which people have insisted on cash in old one-dollar bills, haven't you?

A. What?

Q. You have heard of instances in which people have insisted on cash in old one-dollar bills, but you have never heard of them insisting on cash in new \$1,000 bills?

A. I never had any knowledge of a business transaction where money wasn't paid by check and a receipt given, and then if the recipient of the check wanted to divide it up some way he didn't undertake the responsibility of it. It seemed to me a most unusual and suspicious circumstance, and I thought it was sufficient ground to ask on the behalf of stockholders a return of the money so I included that in the complaint.

Mr. Burroughs subsequently "dropped" this suit. With specific reference to the above allegation in the bill of complaint, Mr. Burroughs felt that he "had no legal evidence of impropriety". (Id., at 15226.)

almost all of which was derived from cash proceeds of its sale of the Terminal Company's notes,<sup>591</sup> in the repurchase of a substantial block of its own \$6 cumulative preferred stock from Wallace Groves, at a profit to him of \$300,000.

Immediately upon the transfer of control of General Investment Corporation to International Equities Corporation all of the officers and directors of General Investment Corporation, including Mr. Devendorf, who was then the president of General Investment Corporation, had resigned and had been replaced by representatives of Ernest B. Warriner.<sup>592</sup> Mr. Devendorf, the largest minority stockholder of General Investment Corporation,<sup>593</sup> requested Mr. Warriner to cause General Investment Corporation to purchase his holdings of between 9,000 and 10,000 shares of its preferred stock<sup>594</sup> on the ground that he was opposed to maintaining a substantial investment in General Investment Corporation unless he was permitted to have representation on the board of directors.<sup>595</sup> At this time Mr. Warriner stated to Mr. Devendorf that he was unwilling to devote any

<sup>591</sup> The Terminal Company notes were sold on November 27, 1936, for \$5,750,000 in cash, less \$150,000 paid to a Buenos Aires banking syndicate. (See *supra*, pp. 594, 577, and 595-6.) Further commissions of \$285,000 were paid to Mr. Billings and Mr. De Ronde in December of 1936 and January 1937. (See *supra*.) On November 30, 1936, the cash position of General Investment Corporation, including the proceeds of the sale of the Terminal Company notes totaled \$5,698,000. (*Moody's Manual of Investments, Banks, etc.*, 1937, at p. 1743.)

<sup>592</sup> *Op. cit. supra*, note 533, at 15171-2. The contract for the sale of control of General Investment Corporation to International Equities Corporation gave American General Corporation the privilege of retaining one of the five directorships of General Investment Corporation until the payment of the entire purchase price for control of General Investment Corporation. (Id., Commission's Exhibit No. 1565.) American General Corporation, however, did not avail itself of this privilege.

<sup>593</sup> Id., at 15175.

<sup>594</sup> Id., at 15184.

<sup>595</sup> Mr. Devendorf testified that Mr. Warriner refused to allow him to remain as a director of General Investment Corporation "to watch the minority interests" (id., at 15181-2):

Q. \* \* \* Will you please tell us why \* \* \* you were prepared to sell your stock at \$87.50 when you knew that it had \$150 behind it?

A. \* \* \* the reason that I wanted to sell it, and I was selling it, and I was willing to take less than I knew at the time that it was worth because I was mistrustful of anyone who wanted to run a corporation without having a representation from minority on the board, and I had heard of two or three investments made subsequent to my leaving the Board that I wasn't pleased with, and I was afraid if I held my stock any longer, we might never see \$87.50 for the stock.

Q. So the situation was that here you were, the largest single stockholder in that corporation, exclusive of the "A" stock, absolutely impotent to do anything under the circumstances.

A. I couldn't even find out what was going on in the corporation.

Mr. Devendorf further testified that he "never quite got it out of my head that there was some connection" between Messrs. Warriner and Groves. (Public Examination, American General Corporation et al., at 25666.)

D. H. Silberberg of D. H. Silberberg & Company, members of the New York Stock Exchange, which had acquired preferred stock of General Investment Corporation in a joint account with Mr. Devendorf (see *infra*, p. 584) and who subsequently joined with Mr. Devendorf in selling his preferred stock in General Investment Corporation to Wallace Groves, stated that he was anxious to dispose of his stock in General Investment Corporation as soon as Mr. Warriner acquired control of the company because he felt that Mr. Warriner was "acting for Mr. Groves." He testified (Public Examination, American General Corporation et al. at 25284-5):

Q. Will you tell us the circumstances under which you happened to dispose of that block of stock to Mr. Groves?

A. Well, the sale was made as the result of the purchase by Mr. Groves of the control of the company from the Founders group. Upon hearing of that purchase—

Q. You mean Mr. Groves?

A. Mr. Warriner was the name given but there was never any question in my mind that Mr. Warriner was acting for Mr. Groves and immediately upon hearing of that purchase we were very desirous of getting out of our position as quickly as it was possible to do so.

Q. You say "we," you refer to yourself and Mr. Devendorf?

A. Myself and Devendorf, yes.

of the funds of General Investment Corporation to the repurchase of its preferred stock.<sup>596</sup> Mr. Warriner, however, in November 1936, prior to the sale of the Terminal Company's notes by General Investment Corporation,<sup>597</sup> introduced Mr. Devendorf to Wallace Groves as an "unhappy stockholder"<sup>598</sup> desirous of selling his preferred stock. Wallace Groves then indicated to Mr. Devendorf that he would not buy Mr. Devendorf's block of preferred stock while the Terminal Company's notes remained "a frozen asset"<sup>599</sup> in the portfolio of General Investment Corporation.

However, early in December 1936 after the Terminal Company's notes had been sold by General Investment Corporation for \$5,750,000, Mr. Groves called on Mr. Devendorf and offered to buy his preferred stock.<sup>600</sup> After some negotiation, Wallace Groves contracted to purchase through his personally owned holding company, Nassau Securities Company, Limited,<sup>601</sup> no less than 17,500 shares of the preferred stock of General Investment Corporation at \$87.50 per share.<sup>602</sup> The terms of Mr. Groves' offer required that the shares which he was to purchase be deposited by January 21, 1937, at the Royal Bank of Canada, Montreal, Canada. Mr. Groves agreed to pay for the deposited shares on January 25, 1937.<sup>603</sup> Mr. Devendorf accepted this offer although at that time the preferred stock had an actual liquidating value of between \$140 and \$150 per share.<sup>604</sup>

Mr. Devendorf and his family, as indicated above, owned only between 9,000 and 10,000 shares of the \$6 cumulative preferred stock of General Investment Corporation.<sup>605</sup> But on January 8, 1937, Mr. Devendorf sent a copy of Mr. Groves' offer to all the preferred stockholders of General Investment Corporation,<sup>606</sup> the names and addresses of which stockholders he procured from Ernest B. Warriner.<sup>607</sup> When examined with respect to this solicitation of preferred stockholders of General Investment Corporation, Mr. Devendorf testified: <sup>608</sup>

Q. And at the time that you sent out this letter, saying that you were selling your stock for \$87.50, to the Nassau Securities Company, Ltd., and saying that you had been fortunate enough to get the same offer for other preferred stockholders, what was the asset value of this preferred stock?

A. I think it was around \$140 to \$150 a share.

Q. So that there was \$150 behind every share of the preferred stock that you were selling to the Nassau Securities Company, Ltd., for \$87.50, and telling every other preferred stockholder that you had gained for them that self-same opportunity.

A. I didn't word it that I was fortunate; I worded it that the same opportunity was open to them and I tried not to give an impression that they should or should not accept it.

<sup>596</sup> Op. cit. supra, note 533, at 15180.

<sup>597</sup> Id., at 15182.

<sup>598</sup> Id., at 20224.

<sup>599</sup> Id., at 20223-4.

<sup>600</sup> Id., at 15182-3.

<sup>601</sup> Id., at 20295.

<sup>602</sup> Id., Commission's Exhibit No. 1569.

<sup>603</sup> Id., at 15179.

<sup>604</sup> As heretofore indicated, on the sale of the shares sold to Mr. Groves, Mr. Devendorf derived a profit in excess of \$600,000. See Appendix F, p. 788.

<sup>605</sup> Op. cit. supra, note 533, at 15184, and Commission's Exhibit No. 1570.

<sup>606</sup> Id., Commission's Exhibit No. 1569.

<sup>607</sup> Id., at 15175-6.

<sup>608</sup> Id., at 15177-9.



Q. But you told them, as you may perhaps remember, "I resigned as director and president of the General Investment Corporation last August, and having sold my common stock will have no longer any connection with the General Investment Corporation when these sales are consummated."

Now, you had been president of the General Investment Corporation, isn't that so?

A. Yes, sir.

Q. And the stockholders had stayed with you throughout this terrific shrinkage?

A. Right.

Q. And you had the right to assume, I suppose, that people were going to rely upon your judgment, isn't that so?

A. No; I didn't assume that, I assumed that anyone who had known me personally, these probably would, and whether or not the stockholders who didn't would, I don't know.

Q. And you weren't going through a futile idle gesture, you were really trying to apprise these people of the opportunity that they had to get \$87.50 for their stock, isn't that so?

A. Yes, sir.

Q. Although at the time it had an asset value of how much?

A. Between \$140 and \$150 per share.

General Investment Corporation itself made no attempt to purchase its \$6 preferred stock on the same or better terms than those offered by Mr. Groves, although Mr. Warriner was aware,<sup>609</sup> at least 11 days prior to its expiration, of the existence of the Groves offer. Nor does the record indicate that Mr. Warriner advised the investment company's preferred stockholders that the actual liquidating value of their stock was approximately \$150 per share as compared with the price of \$87.50 offered by Mr. Groves for the stock.<sup>610</sup>

Instead, Mr. Warriner took steps to cause General Investment Corporation both to finance the purchase of the \$6 preferred stock from the public holders by Mr. Groves and to purchase these identical shares from Mr. Groves at a substantial profit to him. Almost simultaneously with the completion of the agreement by Mr. Groves to purchase the preferred stock held by Mr. Devendorf and others, Ernest B. Warriner caused General Investment Corporation to open an account with the Royal Bank of Canada in Montreal, the bank

<sup>609</sup> Harold S. Maddock, a member of the board of directors of General Investment Corporation, had received on January 9, 1937, a copy of the letter from Mr. Devendorf accompanied by the offer of Nassau Securities Company, Ltd., (id., at 20569-70) to purchase preferred stock of General Investment Corporation. This letter he exhibited to Mr. Warriner on January 10, 1937, and inquired from him as to the ownership of Nassau Securities Company, Ltd. (Ibid.) On the following day, January 11, 1937, Mr. Maddock was informed by Mr. Warriner that Nassau Securities Company, Ltd., was a personal holding company of Wallace Groves. (Ibid.) On January 12, 1937, Mr. Warriner requested Mr. Maddock to resign from the board of General Investment Corporation. (Id., at 20571.) Mr. Maddock resigned from the board of directors of General Investment Corporation and was elected to the board of Standard Investing Corporation, a subsidiary of General Investment Corporation. (Ibid.) Mr. Maddock was replaced on the directorate of General Investment Corporation by W. A. Austin, who, together with Mr. Warriner, had been a nominee of Wallace Groves on the board of directors of Granger Trading Corporation in 1932 when that company was controlled by Mr. Groves. See *supra*, pp. 181-226, *Investment Companies Acquired and Controlled by Wallace Groves*.

<sup>610</sup> *Op. cit. supra*, note 533, at 20655.

which was to be the depository of the investment company's preferred stock under the Groves' offer. Prior to this time, General Investment Corporation had never had an account with the Royal Bank of Canada.<sup>611</sup> Mr. Robinson testified as follows in connection with this policy of the General Investment Corporation in having a large account with the Royal Bank of Canada:<sup>612</sup>

Q. When did you first find out that money was being deposited in the Royal Bank of Canada?

A. About the 1st of December. That was very shortly after the money came up from Buenos Aires, Mr. Warriner said to me that the whole business was in the National City Bank, and he said, "Now, we have this bank and this one, and this one, and I want so much here and so much there, and a million and a half in the Royal Bank of Canada," and that did not make sense to me, but he explained that the Royal Bank had been very helpful to Mr. De Ronde in his operations down at Buenos Aires and he had asked him to return the compliment the best way he could. I still felt that that was a rather generous return of the compliment, and I did not feel that there was anything I could or should do about it except to object.

From time to time, as I had an opportunity, when there were transfers of funds to be made, I would sneak half a million out of the Royal Bank of Canada and boost the balance somewhere else, and then a few days later I would get instructions to put some more money into the Royal Bank of Canada.

Q. From whom? Mr. Warriner?

A. From Mr. Warriner.

\* \* \* \* \*

Q. Did you ask Mr. Warriner why he was sending a million and a half dollars up to Canada?

A. Yes, sir.

Q. What did he say?

A. He said that Mr. De Ronde had asked him to do everything that he could to be nice to the Royal Bank of Canada in exchange for all of the help that they had been to him in effecting the sale of the subway down in Buenos Aires.

Deposits on behalf of General Investment Corporation in this account were commenced early in December,<sup>613</sup> shortly after the sale of the Terminal Company's notes, and by January 23, 1937, \$2,565,000 was on deposit in that bank, an amount sufficient to cover substantially the purchase by the investment company of 27,000 shares of its \$6 preferred stock at \$102 per share.<sup>614</sup>

Between January 18 and January 22, 1937, Mr. Warriner requested several of the members of the board of directors of General Investment Corporation to approve a proposed purchase by the company of its preferred stock from Wallace Groves at \$102 a share. Mr. Warriner stated to the members of the directorate that he was impelled to buy such stock from Wallace Groves because, as Harlan J. Wright, one of the directors, testified, "it would be embarrassing and as he [Warriner] felt, he could not afford to have Mr. Groves an owner of a large

<sup>611</sup> Id., at 15187-8, 20533.

<sup>612</sup> Id., at 15187-8, 15194, 20532-3.

<sup>613</sup> Id., Commission's Exhibit No. 1572.

<sup>614</sup> Ibid.

share of that stock.”<sup>615</sup> Mr. Wright testified as to his conversation with Mr. Warriner about four or five days before the preferred stocks were repurchased as follows:<sup>616</sup>

A. \* \* \* Then he discovered, rather to his surprise, that Mr. Groves had acquired a large block of that preferred stock.

Q. Of the General Investment Corporation?

A. General Investment Corporation preferred stock; yes; and he felt embarrassed; it would have embarrassed the company and embarrassed their relations with the Utility Equities, and embarrassed the plan that he had on foot for Utility Equities and the General Investment Corporation getting together.

\* \* \* \* \*

A. It would be embarrassing and as he felt, he could not afford to have Mr. Groves an owner of a large block of that stock as he had—I want to get this. He did not say definitely, but I got the impression that the Utilities people had understood that he had no connection with Mr. Groves. I had previously asked him that also and was assured that there was no connection with Mr. Groves in his financial work in putting together these companies.

\* \* \* \* \*

Q. And you say this [conversation] took place about four days before the meeting approving the contract; is that right?

A. That is right.

Q. And that meeting took place on January 22, so it must have been about the 18th of January?

A. Approximately; yes.

Q. Did he tell you that Mr. Groves had actually paid for that block of stock and was the owner of it?

A. Yes; he did.

Q. He said that he had paid for it already and that it was his?

A. I am not sure that he said that he had paid for it, but he said that he had bought that stock. Those were his words.

Q. And when he gave you that explanation, that he would be embarrassed by Mr. Groves' association with the situation, he wanted to buy it from Mr. Groves at \$102; is that it?

A. Yes.

It will be recalled, however, that Mr. Warriner, after he had refused to have General Investment Corporation repurchase its preferred stock from Mr. Devendorf, introduced Mr. Devendorf to Mr. Groves as an “unhappy stockholder” desirous of selling his stock.

On January 21, 1937 Wilfred S. Robinson, vice president of General Investment Corporation, had become aware that Nassau Securities Company, Ltd., had accumulated a large block of the preferred stock, and suggested that Mr. Warriner attempt to purchase the stock from Nassau Securities, Ltd., at \$90 a share.<sup>617</sup> Instead of attempting to follow the suggestion of Mr. Robinson, Mr. Warriner, apparently to make it impossible for Mr. Robinson to attend the meeting of the board of directors of General Investment Corporation which was to approve the purchase of that block of preferred stock

<sup>615</sup> Id., at 20625. Mr. Wright testified (id., at 20626-7):

Q. What difficulty did you see between any association between Warriner and Groves?

\* \* \* \* \*

A. I don't know how to express it. Simply that Mr. Groves was active in the street and there were some groups that did not care to cooperate with him in financial transactions.

<sup>616</sup> Id., at 20625, 20627-8.

<sup>617</sup> Id., at 20537.

from Nassau Securities Company, Ltd., at \$102 per share, sent Mr. Robinson to Boston on some "important" business. Mr. Robinson testified:<sup>618</sup>

A. \* \* \* I remember on the 21st—that was a Thursday—we had some conversation about this large block of stock which Nassau Securities Company was about to buy from Mr. Devendorf and others. I asked him—while I did not know who the Nassau was, I suspected and asked him if he did not think that he could perhaps buy that for the corporation at some such price as 90 or less. \* \* \* [On the 21st of January] he was very anxious to have me take the boat and go down to Boston.

\* \* \* \* \*  
Q. January 21st, the day before January 22nd, when the directors of the G. I. C. approved the purchase from the Nassau Securities Company which was controlled by Mr. Wallace Groves of the General Investment Corporation stock at \$102?

A. That's right.

\* \* \* \* \*  
Q. And that is the day that he wanted you to go to Boston on some important business?

A. That is the day he wanted me to go to Boston to learn about this Corporation that the Henderson Bros. were forming. I did not know at the time that there was a directors' meeting called for Friday, January 22nd. That was the first time since I had resigned that I had not been informed of any coming directors' meetings. I told them I felt that I should not go down to Boston right then, and he told me that he was very anxious for me to go and he said he was sure that Mr. Henderson was going to be away Saturday and Monday and he did not want to waste any time on that thing, so I took the sleeper and went to Boston.

Q. Did he give you any indication that he wanted you back in a hurry to attend the meeting the next day?

A. No. I do not know about the meeting the next day. He told me that I had been working pretty hard and I could take a nice lazy week-end. My home was in Springfield originally and he told me——

Q. Not to get back to New York, but after getting through in Boston, to spend the week-end in Springfield?

A. There was a little business that I could do for him in Springfield, and he suggested that I should do that, on Monday, and come back to the office Tuesday morning. \* \* \*

\* \* \* \* \*  
So I took a sleeper and saw Mr. Henderson the following morning, and I asked him what he could tell me about the Central Capital Corporation, and he took a pen out of his pocket and a sheet of paper and wrote off about three lines in three or four minutes, and it did not make sense to me that Mr. Wariner did not know all about that. Maybe he did not, but he has a way if he is interested in that kind of thing, if Mr. Henderson ever mentioned the Central Capital Corporation to him, in the same breath he could have told him all there was to know about it, and I just was getting an uncomfortable feeling about that whole incident, and the checkbooks, the feeling that I was being moved out of New York City for the time being, so I took the next train back to New York, which landed me in town too late, as it was after business hours, probably 7 o'clock or so.

<sup>618</sup> Id., at 20537-40, 20544.

\* \* \* I also noticed around the office a check drawn on the National City Bank to the National City Bank for \$500,000, and I knew that on Thursday when I left that there was no occasion for us to be giving \$500,000 to the National City Bank, so I was a little interested to know what that might mean. In other words, I was naturally—well, not naturally, but anyhow I was very suspicious at the look of everything, so I was suspicious of every detail as I saw it.

\* \* \* I came back downtown and went to the National City Bank and asked some of the officials what use had been made of the check for \$500,000. I was in charge of the records and the stubs, and so on, did not give me adequate information for our bookkeeping. They told me that a young lady had been in there a few minutes before asking to have that exchanged for a cashier's check for \$500,000, payable to the Royal Bank of Canada, and that sort of added fuel to the flame, the whole set-up. In the absence of any information of any sort, it did not look good to a person brought up in the surety business where you see that kind of a set-up preparatory to a killing. I could not believe that Mr. Warriner had planned to go to Canada and steal two or three million dollars, but I did not like the looks of what was going on and it seemed to me that I had better find out just what it meant.

The directors of General Investment Corporation approved on January 22, 1937, the purchase by General Investment Corporation from Nassau Securities Company, Ltd. (Wallace Groves' personal holding company), of not exceeding 27,000 shares of the preferred stock of General Investment Corporation at \$102 per share.<sup>619</sup>

When examined with respect to the consummation of the contract, Mr. Groves testified: <sup>620</sup>

Q. The contract was dated January 21 and was approved by the directors on the 22nd, so Mr. Warriner must have been in New York.

A. I know I made a trip up to Montreal to have the transaction approved and signed.

Q. In Montreal?

A. Yes, sir.

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<sup>619</sup> Id., at 15203 and Commission's Exhibit No. 1571. The contract between General Investment Corporation and Nassau Securities Company, Ltd., further provided that if at any time General Investment Corporation redeemed any of its 6% preferred stock or dissolved and distributed its assets to its stockholders, Nassau Securities Company, Ltd., was to receive the difference between \$102 and the price at which General Investment Corporation redeemed its shares or the liquidating value of such shares in case of its dissolution. (Ibid.) Mr. Groves testified as to the reason for this provision in the contract (id., at 20667):

Q. Do you remember that there was a lawsuit instituted by Mr. Burroughs to restrain the consummation of the contract whereby you got the \$102 and were to get an additional payment in the event of liquidation of G. I. C., or in the event that they retire other people's preferred at a higher price than they paid, or in the event of their acquiring stock at a higher price? Do you remember that lawsuit?

A. There was a lawsuit—when I was dealing with Warriner for the price of that stock, I told him that I did not want him to kid me and take my idea of liquidating the company and mislead me and kid me, and a few weeks afterwards, was he going to liquidate the company? And he said "no" and I said "just so you are not going to do it, will you put that in so that I know that you are not kidding me?" That is how that got in \* \* \*.

Subsequently, a suit brought by Frederick S. Burroughs, a former president of General Investment Corporation, to restrain or in the alternative to rescind the purchase from Mr. Groves of the preferred stock of General Investment Corporation, was settled by the agreement of Groves to cancel this provision of the contract. (Id., at 15222-30.)

<sup>620</sup> Id., at 20661, 20663.

Q. You mean you rode up to Montreal with Mr. Warriner just to place your signature——

A. Mr. Warriner did not go with me. I went without Warriner.

Q. But you went up without Warriner with the contract in your pocket and signed it there and mailed it back? What did you do? How did you get the contract back to New York?

A. I either mailed it back or brought it back.

Q. Don't you remember whether you mailed it?

A. No, sir; I do not.

Q. You mean you took a train with the contract in your pocket, went up to Montreal, signed it on Canadian territory, and came back on the next train——

A. It was not quite as simple as that—In the first place, I went to Montreal a great deal anyway, because I had business there, and they went there and held board meetings——

Q. Can I ask you a question?

A. Yes.

Q. What business do you have in Montreal other than to consummate all of your transactions there? You don't have any industrial company there, do you?

A. Well, I have a number of contacts in Montreal, Mr. Schenker, though I went up to Montreal and held a board meeting of this company, and it was signed pursuant to that authority.

On January 23, 1937, two days after the preferred stock was to have been deposited by the public holders at the Royal Bank of Canada pursuant to the offer of Wallace Groves and two days prior to the date on which Wallace Groves was required to pay these public holders for their preferred stock so deposited, Mr. Warriner went to Montreal to consummate the transactions with Wallace Groves pursuant to the authorization of the board of directors of General Investment Corporation. Mr. Groves denied that he had any influence or control over Ernest B. Warriner or over International Equities Corporation (controlled by Warriner) which in turn controlled General Investment Corporation. However, it will be recalled that Wallace Groves and his brother, George Groves, had "loaned" Ernest B. Warriner the funds necessary to buy the controlling block of International Equities Corporation. Mr. Groves when examined admitted that the controlling block of stock of International Equities Corporation had been hypothecated with Wallace Groves or his brother as collateral for this loan. Mr. Groves testified:<sup>621</sup>

Q. So that the situation was that—Mr. Warriner had hypothecated with the Delaware Trading Corporation—which was nothing else but your brother;<sup>622</sup> is not that so?

A. That is right.

Q. His controlling block of the International Equities Corporation as collateral for the loan of \$139,000 which was used to buy the controlling block and the block he left with the Delaware Trading Corporation as collateral for the loan; is not that so?

A. That is right \* \* \*.

<sup>621</sup> Id., at 20230.

<sup>622</sup> In December 1937 Wallace Groves reacquired his interest in this company. (Id., at 20300, 20476.)

The contract, as finally consummated between the Nassau Securities Company, Ltd., and Ernest B. Warriner on behalf of General Investment Corporation provided for the purchase by General Investment Corporation on January 23, 1937, of 24,591 shares of the preferred stock of General Investment Corporation at \$102 a share,<sup>623</sup> which was the amount of such preferred stock actually deposited by the public holders with the Royal Bank of Canada on January 21, 1937, pursuant to the offer of Nassau Securities Company, Ltd., the personal company of Wallace Groves, to purchase such stock at \$87.50 per share. On January 23, 1937, General Investment Corporation paid \$102 per share for 20,731 of these shares,<sup>624</sup> and on January 25, 1937, Wallace Groves, with a portion of the funds so derived by him, in turn paid \$87.50 per share to the public holders who had deposited their stock with the Royal Bank of Canada on or before January 21, 1937.<sup>625</sup> As a result, Wallace Groves made a net profit of \$300,600 on the 20,731 shares which General Investment Corporation had purchased on January 23, 1937, at \$102 per share and for which Wallace Groves himself thereafter made payment on January 25 at \$87.50 per share.<sup>626</sup>

Recapitulating this transaction, Wallace Groves agreed to pay the public holders of the preferred stock of General Investment Corporation \$87.50 per share on January 25, 1937, provided these holders deposited their shares with the Royal Bank of Canada on or before January 21, 1937. On January 23, 1937, two days after the deposit date, Mr. Warriner caused General Investment Corporation to agree to purchase from Wallace Groves at \$102 per share the exact number of shares which had been deposited by the public stockholders with the Royal Bank of Canada, payment to be made on that date, or two days before Mr. Groves was obligated to pay \$87.50 per share to the public holders. By January 23, 1937, Mr. Warriner had caused General Investment Corporation to have on deposit in the Royal Bank of Canada sufficient funds to pay Wallace Groves \$102 per share for all the deposited stock. On January 23, 1937, Wallace Groves was paid from the General Investment Corporation deposit with the bank a total of \$2,114,562, or \$102 per share for 20,731 shares of General Investment Corporation preferred stock.<sup>627</sup> Of this amount paid to Mr. Groves on January 23, 1937, he paid to the public holders who deposited these preferred shares an aggregate of \$1,813,962.50, or \$87.50 per share.<sup>628</sup> Mr. Groves thereby realized a profit or over

<sup>623</sup> Id., Commission's Exhibit No. 1571.

<sup>624</sup> Id., Commission's Exhibit No. 1575. In addition General Investment Corporation repurchased from Wallace Groves 105,159½ shares of common stock at \$1.50 per share, for a total of \$157,738.80. Mr. Groves had purchased these common shares from Mr. Devendorf as part of his transaction with the latter. (Id., at 20657.)

<sup>625</sup> Id., at 15188-9, 15208, 20525-6. For the balance of the shares which were deposited in the Royal Bank of Canada, Wallace Groves was compelled to pay \$100 per share (id., at 15187 and 20522) for which General Investment Corporation paid \$102 per share on January 26, 1937. (Id., Commission's Exhibit No. 1576.)

<sup>626</sup> Id., at 20525.

<sup>627</sup> This figure excludes the 3,860 shares of preferred stock which Wallace Groves was compelled to purchase from the First National Bank of Boston at \$100 a share, and which were included in the block of preferred stock sold to General Investment Corporation at \$102 a share, and on which block Mr. Groves realized a profit of \$7,720.

<sup>628</sup> Ibid.

\$300,000 on the transaction by the use of the funds of General Investment Corporation without using any of his own funds at any step in the entire transaction.<sup>629</sup>

### (3) INVESTMENT WITH WALLACE GROVES-CONTROLLED PHOENIX SECURITIES CORPORATION IN CERTAIN-TEED PRODUCTS CORPORATION PREFERRED STOCK

During the period of the control of General Investment Corporation by Ernest B. Warriner, a substantial portion of its assets, including a part of the proceeds derived from the sale of the Terminal Company notes, was used by General Investment Corporation in the purchase directly or indirectly from Phoenix Securities Corporation, an investment company controlled by Wallace Groves,<sup>630</sup> of large blocks of the securities of Certain-teed Products Corporation and of Standard Investing Corporation. In April 1936, prior to the acquisition of control by Mr. Warriner and International Equities Corporation of General Investment Corporation, Wallace Groves had suggested that International Equities Corporation participate with Phoenix Securities Corporation in a commitment to purchase the preferred stock of Certain-teed Products Corporation<sup>631</sup> which Phoenix

<sup>629</sup> *Id.*, at 20523-6. Subsequently, General Investment Corporation, then under the control of Henderson Brothers of Boston, sued Ernest B. Warriner and Wallace Groves to recover the approximately \$300,000 profit derived by Mr. Groves as a result of the repurchase from him of its preferred stock by the investment company. Mr. Groves' offer of \$145,000 in settlement of this suit was accepted by the corporation.

On December 1, 1938, Wallace Groves, Ernest B. Warriner, Philip De Ronde, George B. Groves, Delaware Trading Corporation, Nassau Securities Company, Ltd., Philip De Ronde, Ltd., and others were indicted in the United States District Court for the Southern District of New York as participants in an alleged conspiracy to use the mails to defraud General Investment Corporation and its stockholders by the disposition of the proceeds of the sale of the Terminal Company's notes in the purchase of the preferred stock from Mr. Groves and in the payment of commissions in the sum of \$250,000 to Philip De Ronde and Philip De Ronde, Ltd. (See *supra*, pp. 595-601.)

<sup>630</sup> Wallace Groves was chairman of the board of directors of Phoenix Securities Corporation and its largest stockholder, owning approximately 300,000 shares of its common stock or about one-third of such stock outstanding. (Public Examination, General Investment Corporation, at 20482.)

<sup>631</sup> Phoenix Securities Corporation, on April 15, 1936, entered into a contract with George M. Brown, the chairman of the board of directors of Certain-teed Products Corporation, and others to purchase 31,600 shares of the 7% preferred stock of Certain-teed Products Corporation for \$3,000,000 to be paid in installments due May 15, 1936, September 15, 1936, and January 15, 1937. (*Id.*, Commission's Exhibit No. 1581.) This preferred stock which Phoenix Securities Corporation agreed to purchase constituted approximately 50% of such stock then outstanding and, because of a default in dividend payments, was, under the provisions of the charter of Certain-teed Products Corporation entitled to elect a majority of the company's director. (Report of the Securities and Exchange Commission on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Part VII, at 176.) In December 1935, the accumulated unpaid dividends on the preferred stock of Certain-teed Products Corporation amounted to \$3,087,196 or \$49 per share on the 63,004 shares outstanding. (*Ibid.*) The purpose of Phoenix Securities Corporation was to effect a recapitalization of Certain-teed Products Corporation which would eliminate the dividend arrearages on its preferred stock. On June 24, 1936, the stockholders of Certain-teed Products Corporation voted to amend the company's charter to create a new prior preferred stock, and the preferred stockholders of the company were offered this new preferred stock or a unit of such new preferred stock and common stock for their holdings of the old preferred stock. (*Id.*, at 181.) The recapitalization plan did not, however, disturb Phoenix Securities Corporation's working control of Certain-teed Products Corporation. (*Ibid.*)



Securities Corporation was unwilling to undertake alone.<sup>632</sup> International Equities Corporation adopted the suggestion of Wallace Groves and agreed to participate with Phoenix Securities Corporation in this investment to the extent of \$1,000,000,<sup>633</sup> notwithstanding the fact that Certain-teed Products Corporation had been losing money steadily for six years.<sup>634</sup>

As of August 18, 1936, International Equities Corporation had paid to Phoenix Securities Corporation \$420,961 on account of this commitment.<sup>635</sup> However, on August 18, 1936, fifteen days after it had acquired control of General Investment Corporation, and shortly after Mr. Billings had informed Mr. Warriner of the status of his negotiations for the sale of the Terminal Company's notes, International Equities Corporation transferred, with the approval of Wallace Groves, this million-dollar participation in the stock of Certain-teed Products Corporation to General Investment Corporation.<sup>636</sup> The reason advanced for this assignment of International Equities Corporation's participation was that General Investment Corporation had assets of \$10,000,000 and would be in a better position to make the investment.<sup>637</sup> General Investment Corporation paid to International Equities Corporation \$420,961 as its initial payment on this commitment and eventually paid to the Phoenix Securities Corporation the balance of the commitment with funds derived in part from the sale of the Terminal Company notes.<sup>638</sup>

As a result of this transaction International Equities Corporation derived \$420,961 in cash and was relieved of a \$579,039 liability still due on this commitment, thus placing itself, at the expense of its subsidiary, General Investment Corporation, in a financial position to meet the future installments for the purchase of control of General Investment Corporation itself. As has been stated, when Mr. Warriner acquired control of International Equities Corporation, it had assets of \$1,165,000. By the close of August 1936, of these funds, \$441,027 had been used to repurchase its own outstanding stock.<sup>639</sup> Between August 1936 and March 1937, International Equities Corporation paid American General Corporation a total of \$800,000<sup>640</sup> on account of the purchase price for control of General Investment Corporation. Obviously these payments could not have been met if International Equities Corporation had to retain and pay this \$1,000,000 commitment to purchase the preferred stock of Certain-teed Products Corporation. As a consequence General Investment

<sup>632</sup> Op. cit. supra, note 533, at 15288-9.

<sup>633</sup> Id., at 15198-9, 20484, 20487-8, and Commission's Exhibit No. 1584.

<sup>634</sup> Id., at 15284-5, 15290.

<sup>635</sup> Id., Commission's Exhibit No. 1583.

<sup>636</sup> Ibid.

<sup>637</sup> Id., at 15300-2.

<sup>638</sup> On September 14, 1936, General Investment Corporation paid \$241,207.75 on account of the commitment, and on January 2, 1937, paid the balance of \$436,592. (Id., Commission's Exhibit No. 1585.) Apparently this final payment was made in part from the proceeds of the sale of the Terminal Company notes, since, General Investment Corporation on November 30, 1936, had only \$4,800 in cash other than the cash derived from the sale of the Terminal Company notes.

<sup>639</sup> Of this sum, \$266,000 was expended on August 21, 1936, to meet the personal obligation of Mr. Warriner to purchase International Equities Corporation stock from Louis J. Kolb and others. (See note 551, supra.)

<sup>640</sup> Op. cit. supra, note 533, at 15300-2, and Commission's Exhibit No. 1565.

Corporation, having cash derived from the sale of the Terminal Company notes, was compelled by its controlling persons to assume this \$1,000,000 commitment.

On May 31, 1937, General Investment Corporation held, after a recapitalization of Certain-teed Products Corporation in June 1936, a total of 11,184 shares of the 6% prior preferred stock and 29,420 shares of the common stock of Certain-teed Products Corporation at a cost of \$691,181.93 and \$423,910.06, respectively.<sup>641</sup> On May 31, 1938, General Investment Corporation still held 7,444 shares of this preference stock and 28,500 shares of this common stock with a total market value of \$309,521.50,<sup>642</sup> indicating an unrealized loss on these securities of \$561,192.

#### (4) PURCHASE OF COMMON STOCK OF STANDARD INVESTING CORPORATION FROM THE WALLACE GROVES-CONTROLLED PHOENIX SECURITIES CORPORATION

General Investment Corporation, on December 17, 1936, two weeks after it had sold the Terminal Company notes, also purchased 163,000 shares or approximately 39% of the common stock of Standard Investing Corporation, an investment company of the general management type,<sup>643</sup> from Phoenix Securities Corporation for approximately \$3.93 per share, or a total of \$641,431.<sup>644</sup> On this sale, Phoenix Securities Corporation made a profit of \$40,792.67.<sup>645</sup>

This block of stock of Standard Investing Corporation had been previously acquired by Phoenix Securities Corporation in an unsuccessful effort to obtain control of Standard Investing Corporation. However, the investment banking firm of Brown Brothers, Harriman & Company, the sponsor of Standard Investing Corporation had resisted<sup>646</sup> the efforts of Phoenix Securities Corporation to acquire control of Standard Investing Corporation, on the ground that that banking firm had "sponsored" and "distributed"<sup>647</sup> the securities of Standard Investing Corporation to the public on the representation that the company would operate as a diversified investment trust.<sup>648</sup> Prior to the annual meeting of the stockholders of Standard Investing Corporation in March 1936, Brown Brothers, Harriman & Company had refused to turn over control of Standard Investing Corporation to Phoenix Securities Corporation although the latter was

<sup>641</sup> Public Examination, American General Corporation, Commission's Exhibit No. X3423-F.

<sup>642</sup> Annual Report, General Investment Corporation, May 31, 1938.

<sup>643</sup> As at December 31, 1936, Standard Investing Corporation had outstanding \$2,941,000 principal amount of convertible debentures, 55,156 shares of preferred stock entitled to a preference in the corporate assets of \$100 per share and accrued dividends, and 394,591 shares of common stock. (*Moody's Manual of Investments, Banks, etc.*, 1937, at pp. 1744-5.)

<sup>644</sup> Op. cit. supra, note 533, Commission's Exhibit No. 1580.

<sup>645</sup> Ibid.

<sup>646</sup> Id., at 15260.

<sup>647</sup> Ibid.

<sup>648</sup> Reply to the Commission's questionnaire for Standard Investing Corporation, Part I, Exhibit 8 et seq. Walter S. Mack, Jr., president of Phoenix Securities Corporation, testified that Mr. Ray Morris of Brown Brothers, Harriman & Company had informed him that "he [Morris] didn't think that Phoenix's type of operation was the type of operation that they had conceived for Standard when they had distributed Standard Stock". (Public Examination, General Investment Corporation, at 15260.)

the largest stockholder.<sup>649</sup> At the annual meeting of Standard Investing Corporation's stockholders in March 1936, Brown Brothers, Harriman & Company had defeated Phoenix Securities Corporation in a proxy fight for control of the management of the company.<sup>650</sup> Although thereafter Phoenix Securities Corporation continued to acquire common stock of Standard Investing Corporation in the market, by December 1936, Phoenix Securities Corporation was apparently not unwilling to dispose of its holdings of the common stock of Standard Investing Corporation.

At this time, both Mr. Warriner, on behalf of General Investment Corporation, and Henderson Brothers of Boston (who subsequently acquired control of General Investment Corporation from the Warriner interests), on behalf of various investment companies which they then controlled,<sup>651</sup> approached Phoenix Securities Corporation with offers to purchase its common stock in Standard Investing Corporation. Phoenix Securities Corporation sold its shares, as has been stated, on December 17, 1936, to General Investment Corporation, which, Mr. Henderson testified, "had the inside track <sup>652</sup> with Phoenix Securities Corporation because of the association of Mr. Warriner with Mr. Groves. Brown Brothers, Harriman & Company approved of this sale by Phoenix Securities Corporation to General Investment Corporation only after it had received assurances that "Mr. Warriner wasn't merely another way of saying 'Mr. Groves'."<sup>653</sup> Simultaneously Brown Brothers, Harriman & Company sold its minority holdings of Standard Investing Corporation common stock <sup>654</sup> to the Henderson Brothers and investment companies controlled by them; <sup>655</sup> and the Henderson Brothers received a minority representation <sup>656</sup> on the board of directors of Standard Investing Corporation.

By March 1937, General Investment Corporation had acquired 204,852 shares of the common stock of Standard Investing Corpora-

<sup>649</sup> In March 1936, Phoenix Securities Corporation held approximately 120,000 shares of Standard Investing Corporation common stock, and Brown Brothers, Harriman & Company held only 30,000 shares of such stock. (Id., at 15241-2.)

<sup>650</sup> Id., at 15242-3, 15260-1.

<sup>651</sup> Prior to July 1934, Henderson Brothers of Boston who were then primarily engaged in the retail distribution of radios, electric refrigerators, and washing machines (id., at 15316) had a substantial interest in only one small investment company, World Investment Trust. (Id., at 15312-3.) Thereafter, between July 1934 and February 1937, Henderson Brothers acquired, at a personal expenditure of between \$40,000 and \$80,000, control of Beacon Participations, Inc., Atlantic Securities Company of Boston, and Allied International Investing Corporation, three investment companies having aggregate assets in excess of \$2,000,000. As each of these companies was acquired by Henderson Brothers, the assets of these investment companies were used to purchase control of other investment companies. (Id., at 15312, 15323, 15327.) In March 1937, Henderson Brothers acquired control of Standard Investing Corporation, General Investment Corporation, and International Equities Corporation, in a series of transactions which will be described infra.

<sup>652</sup> Id., at 15334.

<sup>653</sup> Id., at 15251.

<sup>654</sup> Ibid.

<sup>655</sup> Henderson Brothers and their controlled investment companies acquired their holdings of Standard Investing Corporation common stock from Brown Brothers, Harriman & Company at a price of \$3.50 per share and the Henderson Brothers publicly offered to acquire additional shares of the common stock from all holders of the stock at a price of \$3.50 per share. (Id., at 15337, 15354.) However, General Investment Corporation purchased Phoenix Securities Corporation's holdings of such stock at a price of \$3.93 per share.

<sup>656</sup> Id., at 15339.

tion at a total cost of \$812,993,<sup>657</sup> notwithstanding the fact that the common stock of Standard Investing Corporation had no asset value and that the total assets of the company would have had to appreciate by approximately \$2,000,000 before such common stock would have acquired any asset value.<sup>658</sup>

The acquisition of control of Standard Investing Corporation gave Mr. Warriner control of the particular investment company which was ultimately used as the means of realizing for himself a personal profit of approximately \$1,900,000 at the time he disposed of his controlling interest in his investment companies.

On March 2, 1937, Mr. Warriner caused General Investment Corporation to sell its controlling interest in Standard Investing Corporation,<sup>659</sup> which had, as indicated above, total assets of approximately \$9,000,000, to Central Capital Corporation, an investment holding company controlled by the Henderson Brothers of Boston.<sup>660</sup>

<sup>657</sup> Id., Commission's Exhibit No. 1574.

<sup>658</sup> As at December 31, 1936, the net assets of Standard Investing Corporation applicable to its capital stock after deducting bonded indebtedness and other liabilities, totaled \$5,268,796, and the preferred stock had an asset value of approximately \$96 per share. No deduction has been made from the unrealized appreciation of investments for liabilities with respect to federal excess profits tax or surtax on undistributed profits. If these taxes are taken into account, the asset value of each share of preferred stock is \$84.10. (*Moody's Manual of Investments, Banks, etc.*, 1937, at 1744.) There were outstanding 55,156 shares of preferred stock having a liquidating preference in assets of \$5,515,600 plus accrued unpaid dividend at \$1,868,410, or a total prior claim of \$7,384,010. (Ibid.)

<sup>659</sup> Op. cit. supra, note 533, at 15350.

<sup>660</sup> Id., at 15341-2. When examined with respect to the negotiations which Mr. Henderson and his associates carried on with Mr. Warriner looking to the acquisition of control of Standard Investing Corporation, and thereafter International Equities Corporation, Mr. Henderson testified (id., at 15340-2):

A. It must have been about the 15th of February of this year [1937] and one day we received a telephone call from Mr. Warriner in New York. Mr. Warriner knew we were interested at various times in getting control of big blocks of investment trust securities, either with or without control, if complete.

He called us and said he had a big proposition for us in connection with investment trusts and he suggested we both come to New York, Mr. Moore and myself. I went alone because we were getting busy and I reached New York the next morning and found Mr. Warriner there in a very agitated state of nervousness, and he told me he was on the verge of a breakdown and the doctor told him he had to gradually divest himself of his investment trust holdings, it had been too much for him and he had not been able to manage and make portfolio changes and he wanted to start unloading his interests in his companies.

Q. Yes; go on.

A. At that time we called in Mr. Moore and we started discussing the question of the companies he was willing to sell, and at what price. And we discussed all kinds of angles, the possible purchase price and the discussions were very difficult because Mr. Warriner would break down and say he was sick and have to lie down an hour or two and we went back and forth from Boston to New York five or six times during the succeeding ten or twelve days.

Q. Were these negotiations looking toward the acquisition of the International Equities Corporation stock?

A. We discussed International Equities and we discussed Standard Investing.

Q. Yes.

A. He told us at that time he had all kinds of theories of what he wanted to sell and the only thing we could come to an agreement on the price was Standard Investing and that was the only thing we knew enough about to make a deal.

Q. What was the result of that?

A. The result was we purchased 240,000 shares of that stock from him.

Q. Of what corporation?

A. Of Standard Investing Corporation for \$850,000, payable \$400,000 in cash practically, some within ten days and the balance of \$450,000 over a period of several months.

Q. How did Standard Investing Corporation come into the International Equities Corporation picture?

A. About a week or two later, Warriner came to Boston and said he was ready to sell the rest.

Q. As a result of these negotiations did Standard Investing Corporation buy control of International Equities Corporation?

A. That is correct.

Q. How much did it buy?

A. Between 70 and 80 per cent of it.

Q. For an aggregate in dollars of how much?

A. \$2,000,000.

Two weeks later Mr. Warriner sold his controlling interest in International Equities Corporation, which controlled General Investment Corporation, to Standard Investing Corporation, for a cash payment of \$2,000,000.<sup>661</sup> To meet this payment of \$2,000,000, Standard Investing Corporation was compelled to liquidate diversified portfolio securities having a value of \$2,000,000. Ernest F. Henderson testified:<sup>662</sup>

Q. So that as far as Standard Investing Corporation is concerned, you had a diversified portfolio, did you?

A. Yes.

Q. And you liquidated enough of the portfolio to raise \$2,000,000, is that right?

A. Yes.

Q. And then you had \$2,000,000 invested in the International Equities Corporation stock?

A. That is right.

As a result of these transactions, Mr. Warriner, who had invested only approximately \$139,000 in his purchase of the controlling block of International Equities Corporation stock, derived a profit of approximately \$1,860,000 on the sale of this block.<sup>663</sup> This profit to Mr. Warriner came from the funds of Standard Investing Corporation which Mr. Warriner had controlled only two weeks before.

Mr. Groves denied that he received any part of this \$2,000,000, except the \$150,000 which was paid to him in satisfaction, with interest, of the \$139,000 originally advanced to Mr. Warriner by the Delaware Trading Corporation (the Groves personal holding company) to enable him to purchase his first block of stock in International Equities Corporation. Mr. Groves testified:<sup>664</sup>

Q. \* \* \* Do you deny, Mr. Groves, that of the \$2,000,000 that Mr. Warriner got for his International Equities Corporation stock that you got any portion of that \$2,000,000 other than the \$139,000 that he had owed either to you or your brother?

A. I got no portion of that; as far as I know I never got any money from him at all. I got no portion of the proceeds of that sale, if that is the definite answer you want.

Q. What portion of the proceeds of the sale did you get?

A. \* \* \* He gave Delaware Trading Corporation a check for one-hundred-and-fifty-odd thousand dollars, which included \$139,000 plus interest, in full payment of the obligation, and I think that he gave it after they paid him the money.

\* \* \* \* \*

Q. The Delaware Trading Corporation loaned him \$139,000, which was used to buy part of the stock which was ultimately sold for \$2,000,000?

A. Yes.

<sup>661</sup> Id., at 15342.

<sup>662</sup> Id., at 15351.

<sup>663</sup> The record suggests that it was contemplated by Mr. Warriner and the Henderson Brothers that the assets of Standard Investing Corporation, after its control passed to the Henderson Brothers, would be used to purchase control of International Equities Corporation from Mr. Warriner. (See testimony quoted in note 660, supra.)

<sup>664</sup> Id., at 20471-2.

Q. And after Mr. Warriner got \$2,000,000 for that stock the only monies you received out of that \$2,000,000, either you or your brother or any personal holding corporation of you or your brother, was the loan of \$139,000 plus interest?

A. \* \* \* I received no money personally at all. The only money indirectly I received was through the interest I had in the Delaware Trading Corporation through the repayment of the loan, and he did repay the loan.

\* \* \* \* \*

Q. You say you reacquired your interest in the Delaware Trading Corporation prior to the time that the actual sale by Warriner of his International Equities Corporation stock took place to Standard Investing Corporation. Now, who represented you at the closing. You had physical possession of the International Equities Corporation stock, didn't you?

A. Yes, sir.

\* \* \* \* \*

Q. \* \* \* I just want to know what the fact was. Did you get your \$139,000 before you released the collateral, or did he pay you the \$139,000 and then did you turn the International Equities Corporation stock over to him?

A. I believe it was about simultaneously, because I know that I was anxious about the money, and I think that was the reason I went up to Montreal, to get it.

Q. So now you say you did go to Montreal to get the money?

A. I told you I was in Montreal about that time.

Q. Did he tell you he was going to Montreal to close the deal?

A. I think he told me that \* \* \*.

\* \* \* \* \*

Q. Do you remember where the check was turned over to you?

A. I am sure it was in Canada \* \* \*.

\* \* \* \* \*

Q. Was it at the Royal Bank of Canada?

A. The check, I suppose it was; it was drawn on the Royal Bank. The check was drawn on the Royal Bank, and I think it was turned over there.

\* \* \* \* \*

Q. Is it your testimony that while the loan was outstanding from November of 1935 to March of 1937, this loan of \$139,000, and what you just characterized as the controlling block of stock, that you did not participate or influence the management of International Equities Corporation?

A. I did not, to my knowledge—Warriner would come to me and ask questions and advice. Sometimes he worried me about it, but I at no time was director in any of those companies and I don't think that I took any interest in the management. Of course, I didn't. Why should I. I am of an inquisitive nature and I may have talked about it.

Q. Did you say "inquisitive" or "acquisitive"?

A. Acquisitive too, sometimes, if it would do me any good.

### c. Effect of Ernest B. Warriner's Management Policies on Stockholders of General Investment Corporation

As has been described, almost all of the \$5,750,000 cash derived by General Investment Corporation from the sale of its Terminal Company notes as well as of the cash on hand when Mr. Warriner acquired control of General Investment Corporation was caused to be invested by General Investment Corporation in "special situations"

with which Wallace Groves was either directly or indirectly associated, in the repurchase of the corporation's own preferred stock from Mr. Groves, at a profit to Mr. Groves, and in the payment of commissions to Mr. Groves' associate, Mr. De Ronde.

Approximately \$2,500,000 of this cash was used by General Investment Corporation to repurchase its own \$6 preferred stock from Wallace Groves at a profit to him of approximately \$300,000. General Investment Corporation had invested, at the suggestion of Wallace Groves, \$1,000,000 in the purchase of a large block of the preferred stock of Certain-teed Products Corporation as a subparticipation in the purchase of \$3,000,000 of such stock by the Groves-controlled Phoenix Securities Corporation. In addition, Phoenix Securities Corporation sold to General Investment Corporation a controlling block of the common stock of Standard Investing Corporation for \$641,000. An aggregate of approximately \$4,150,000 of this cash was therefore expended in the purchase of securities in which Wallace Groves was directly or indirectly interested. In addition, \$400,000 was paid to Groves' associate, Mr. De Ronde, and ostensibly to the South American bankers as commissions in connection with the sale of the Terminal Company notes. The remaining cash which General Investment Corporation had acquired from its sale of the Terminal Company's notes was invested during the period of Mr. Warriner's management of General Investment Corporation in the purchase for \$1,137,687.50 of a 26% interest in Utility Equities Corporation, an investment company of the general management type.<sup>665</sup>

As a result of these investments and disbursements, the announced policy of General Investment Corporation of investing in diversified securities was abandoned, although this policy had been inaugurated in 1933 with the knowledge and consent of the stockholders after the company had suffered substantial losses as a result of its previous concentration in public utility securities.<sup>666</sup> Without the prior knowledge or consent of its stockholders General Investment Corporation, under the management of Mr. Warriner, had become essentially a holding company for other investment companies. The only other substantial investment of General Investment Corporation consisted of a large holding of Certain-teed Products Corporation preferred stock.

## **H. Management of General Investment Corporation by Henderson Brothers, of Boston, Mass. (March 1937-June 1939)**

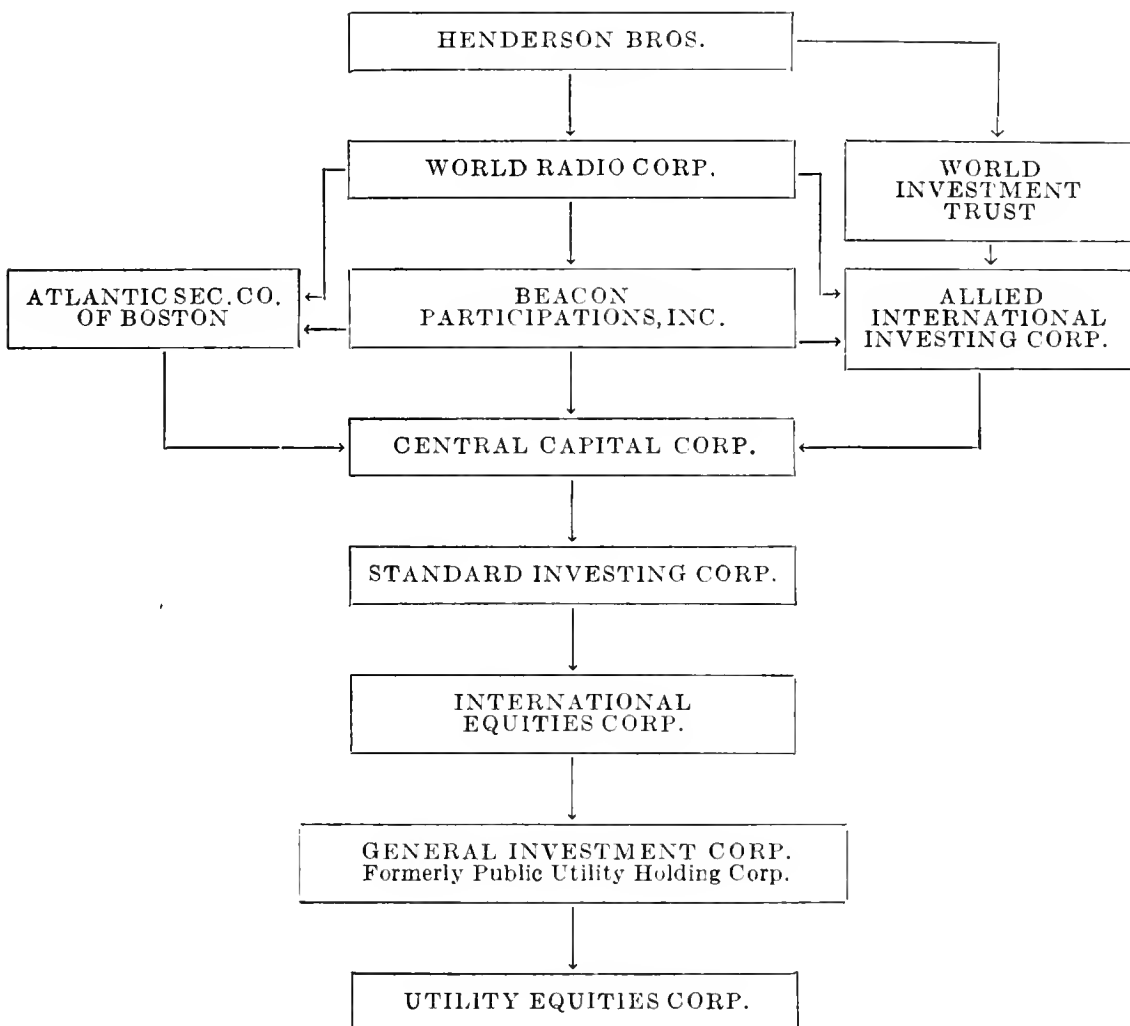
Control of General Investment Corporation, as has been stated, passed on March 9, 1937, to Henderson Brothers of Boston evidently without the prior knowledge or consent of the stockholders of the

<sup>665</sup> *Op. cit. supra*, note 533, at 15197, and Commission's Exhibit No. 1574. As at May 31, 1937, General Investment Corporation held 153,900 shares of Utility Equities Corporation common stock at a cost of \$1,183,615. (Public Examination, American General Corporation et al., Commission's Exhibit No. X3423F.) On May 31, 1938, 144,400 shares of this stock was still retained at a market value of \$270,750 (Annual Report of Standard Investing Corporation, May 31, 1938), indicating an unrealized loss of \$839,830 on the shares retained, exclusive of whatever profit or loss was realized on the 9,500 shares sold between balance sheet dates. See *supra*, note 563, for present status of Utility Equities Corporation.

<sup>666</sup> See *supra*, p. 578.



investment company. As a result of the passage of control, General Investment Corporation became one of the constituent investment companies in the pyramid of such companies controlled by Henderson Brothers, of Boston. In this structure of investment companies, General Investment Corporation was controlled by International Equities Corporation, which in turn was controlled by Standard Investing Corporation. Standard Investing Corporation itself was controlled by other investment companies which were directly controlled by Henderson Brothers themselves. The following chart <sup>667</sup> indicates the position of General Investment Corporation in the series of investment companies under the control of the Henderson Brothers:



By March 1937 the assets of General Investment Corporation, under the management of Ernest B. Warriner, had declined from approximately \$9,300,000 (taking into account the \$7,500,000 proceeds from the sale of the Terminal Company notes) to \$6,300,000 <sup>668</sup> largely by reason of the repurchase of its own preferred stock for about \$2,500,000. Between March 1937 and May 31, 1938, the assets of General Investment Corporation declined from approximately \$6,300,000 to \$2,800,000, most of which was invested in real estate

<sup>667</sup> Id., Commission's Exhibit No. 1579. See supra note 563 for discussion of transfer of control of General Investment Corporation to American General Corporation.

<sup>668</sup> Op. cit. supra, note 533, Commission's Exhibit No. 1574.

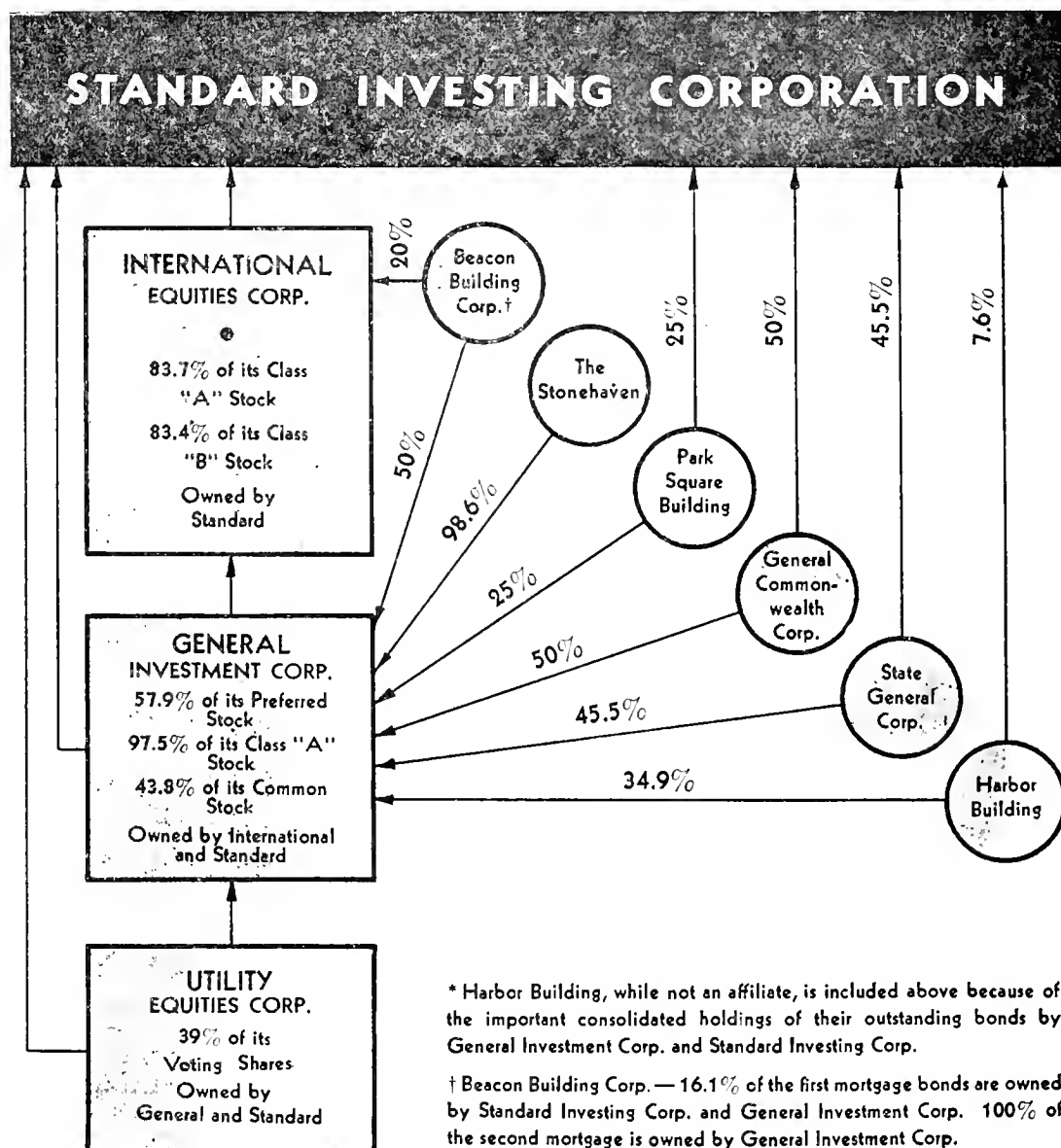


situated in and around Boston, Massachusetts.<sup>669</sup> Chart 5 indicates the degree to which the assets of General Investment Corporation are at present invested in real estate.

CHART 5

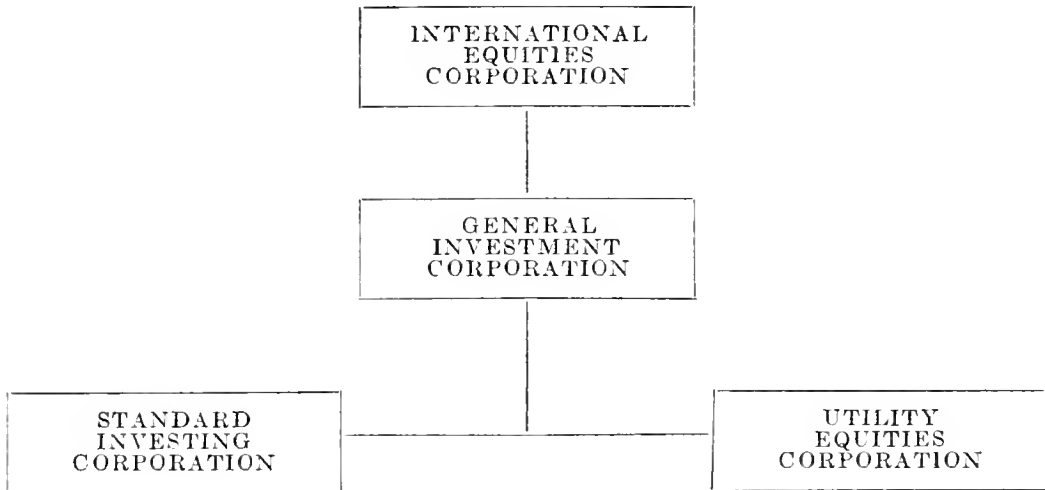
## Standard Investing Corporation and its Affiliates\*

- Rectangles Indicate Investment Companies  
○ Circles Indicate Real Estate Companies



<sup>669</sup> See Annual Report of Standard Investing Corporation, June 30, 1938. The decline of \$3,500,000 during the period of control by Henderson Brothers was not entirely the result of their investment policies. Substantial realized and unrealized losses during the period were suffered on the inherited investments. In Certain-teed Products Corporation and Utility Equities Corporation alone the unrealized losses totaled approximately \$1,401,022. (See supra.)

On the other hand, prior to the sale of control by Mr. Warriner of both Standard Investing Corporation and International Equities Corporation which in turn controlled General Investment Corporation, to the Henderson Brothers, General Investment Corporation itself owned the controlling block of the common stock of Standard Investing Corporation. The following chart indicates the position of General Investment Corporation in the system of investment companies which had been controlled by Ernest Warriner:



It will be recalled that Standard Investing Corporation was a leverage investment company so that the stockholders of General Investment Corporation, when it controlled Standard Investing Corporation, obtained the leverage advantage of the common stock of Standard Investing Corporation. As a result of the transfer the common stock of Standard Investing Corporation held by General Investment Corporation to investment companies controlled by the Henderson Brothers, the stockholders of General Investment Corporation were deprived of the leverage advantage of its previous ownership of the common stock of Standard Investing Corporation.

### I. Conclusions

General Investment Corporation (formerly The Public Utility Holding Corporation of America), which was organized on September 5, 1929, by the United Founders Corporation group of investment companies and The Harris Forbes Corporation (a subsidiary of Harris, Forbes & Company, a leading New York investment banking house) raised ultimately an aggregate of approximately \$78,634,000 by the issuance and resales of its capital stock. As of May 31, 1936, about two months prior to the date when control of General Investment Corporation was transferred by the sponsors to a new management, the investment company had sustained a loss of approximately \$70,604,000 in its operations, or approximately 90% of its paid-in capital.

The most substantial part of this loss was sustained by the investment company in transactions in which the sponsors had a direct or indirect pecuniary interest. During the management period of the

United Founders Corporation group and Harris Forbes & Company the General Investment Corporation and its subsidiary, United States & Overseas Corporation, invested and reinvested an aggregate of \$107,000,000 in transactions in which the sponsors either had a direct pecuniary interest or which were otherwise permeated with conflicts of interest between the investment companies and their managements. On these transactions, the two investment companies lost approximately \$53,000,000, or over two-thirds of the total losses sustained in their operation.

From its very inception, General Investment Corporation was caused by its sponsors to become interested in ventures in which these sponsors were on both sides of the transaction—representing the interest of the investment company and their own interests. At the origination of the company, the sponsors who granted themselves the right to distribute the common stock of General Investment Corporation, sold these securities to the public at prevailing market prices, which for a period averaged \$26 a share. The investment company then issued this stock at \$12.50 per share to these sponsors, who made, in the form of profits and commissions, an aggregate of approximately \$6,780,000. Immediately upon the organization of the General Investment Corporation, both the sponsors sold directly to the dominated investment company \$19,500,000 of utility stocks upon which transaction the sponsors realized a profit of \$4,500,000.

While managed by Harris, Forbes & Company, the investment company engaged in numerous transactions which were permeated with a variety of conflicting interests. As was stated by one of the senior officers of the sponsoring investment banking firm, "it was impossible for the investment banker that formed these investment trusts to use the same kind of judgment that they would have used if they had been only interested in the investment company." During this management period by far the greater part of the funds of the investment company were used to expand the resources of the utility systems for which Harris, Forbes & Company was the banker; to take over financing obligations of the sponsors; to guarantee and eventually to acquire an issue distributed to the public by Harris Forbes & Company; to purchase securities from investment bankers associated with Harris Forbes & Company; and to make loans to German banking clients of some of the sponsors.

In August 1936, when the value of the assets of the investment companies had shrunk to less than \$10,000,000, control of the investment company was sold to International Equities Corporation, which was controlled by Ernest B. Warriner, who had been financed by Wallace Groves and his brother. The General Investment Corporation realized during the Warriner regime approximately \$5,750,000 in cash upon the sale of its investment in a South American terminal company, and the investment company was immediately caused to disburse the greater part of this cash in transactions and ventures in which Wallace Groves and his associates were directly or indirectly pecuniarily interested. Approximately \$2,500,000 was used to repurchase from Wallace Groves the corporation's outstanding pre-

ferred stock upon which Groves realized a profit of approximately \$300,000 without investing any funds in the transaction. The sum of \$400,000 was paid to one Philip De Ronde, an associate of Wallace Groves and persons affiliated with Mr. De Ronde, as "commissions" for the sale of the South American Terminal Company. The investment company was caused to make part of the payments for a \$1,000,000 block of stock of the Certain-teed Products Corporation which General Investment Corporation acquired from the International Equities Corporation, controlled by Mr. Warriner; and to purchase for approximately \$650,000 a block of Standard Investing Corporation stock, another investment company, which Phoenix Securities Corporation, an investment company dominated by Wallace Groves, had accumulated in an unsuccessful attempt to obtain control of the Standard Investing Corporation. As a result of these and other investments in special situations made during the Ernest B. Warriner management period which terminated when he sold control of General Investment Corporation in March 1937 to Henderson Brothers of Boston, General Investment Corporation sustained further substantial losses.

Throughout the history of General Investment Corporation, the fundamental nature of its business and the investment policy was changed without the prior consent of its security holders. During the first management and expansion period, the business of the investment company was changed from investing in the securities of public-utility companies to the acquisition and control of public-utility enterprises, for which the sponsor was the banker, and activities of an investment-banking nature, such as the extension of credit to foreign clients of the sponsors. During the second management period the major portion of the funds of the investment company were used to reacquire its own outstanding preferred stock from Wallace Groves, to acquire other investment companies, and to make substantial concentrated investments in companies in which associates of the sponsor had special interests. During the third management period, a substantial portion of the funds were invested in real-estate enterprises. On June 29, 1939, control of General Investment Corporation was reacquired by American General Corporation, and in place of the real estate properties General Investment Corporation was to receive \$1,050,000 in cash from International Equities Corporation.

# **XI. EASTERN UTILITIES INVESTING CORPORATION<sup>1</sup> (AN INVESTMENT COMPANY CONTROLLED AND OPER- ATED BY H. C. HOPSON AND THE ASSOCIATED GAS & ELECTRIC SYSTEM)**

## **A. Summary**

Eastern Utilities Investing Corporation<sup>2</sup> was incorporated under the laws of Delaware on August 4, 1922, by H. D. Walbridge & Co., Inc. The company remained dormant until about March 20, 1924, when the controlling blocks of stocks of various water, gas, and light companies operating in western Pennsylvania<sup>3</sup> were transferred to it by H. D. Walbridge & Co., Inc., which received in consideration therefor 45,000 shares of \$7 preferred stock, 165,000 shares of its common stock, and an option to purchase the debentures of Eastern Utilities Investing Corporation. On December 31, 1924, the consolidated balance sheet of Eastern Utilities Investing Corporation (then known as Pennsylvania Electric Corporation) showed that its operating company subsidiaries had plant and property amounting to approximately \$77,000,000. At that time, the public held approximately \$39,500,000 of bonds and over \$10,000,000 of stocks of these subsidiary companies. In addition, Eastern Utilities Investing Corporation had outstanding approximately \$5,000,000 principal amount of debentures, approximately 44,000 shares of \$100 par 7% preferred stock and approximately 160,000 shares of its no par common stock.

On June 4, 1925, H. D. Walbridge & Co., Inc., contracted to sell to Associated Gas and Electric Company its and its associates' holdings of common and preferred stock of Eastern Utilities Investing Corporation, which were at least 114,610 shares of common and 24,019 shares of preferred. Additional shares of common were delivered under the contract. Through this and public purchases Associated Gas and Electric Company acquired about 165,000 shares of the outstanding 175,000 shares of common stock. This acquisition of Eastern Utilities Investing Corporation increased the total consolidated assets of Associated Gas and Electric Company by at least 72%. Thereafter, Eastern Utilities Investing Corporation was under the complete control and domination of H. C. Hopson and J. I. Mange, who controlled Associated Gas and Electric Company and other Associated Gas & Electric System companies through various Massachusetts common-law trusts.

When formal control was assumed by the Associated Gas and Electric Company on September 23, 1925, the composition of the board of directors of the Eastern Utilities Investing Corporation was immediately changed. H. C. Hopson (vice president, treasurer, and director of Associated Gas and Electric Company) was made vice president and director of Eastern Utilities Investing Corporation;

<sup>1</sup> The material on which the report on this company is based consists of (1) the reply to the Commission's questionnaire prepared by a service staff serving the Associated Gas & Electric System and pursuant to the direction of the Comptroller of the "System"; (2) a limited accounting investigation by accountants of the Commission's staff of certain particular transactions as reflected in the "System's" books; and (3) a subsequent public examination.

The public examination was conducted by Carlile Bolton-Smith, as counsel, who supervised the preparation of the report on this company, assisted by Philip R. Friend, financial analyst of the public utilities division, and by R. C. Gilles, of the economic and analysis section, and other members of the staff of the Investment Trust Study.

Occasional reference is made to the record of the examination under Section 21-A of the Bankruptcy Act, *In the Matter of Eastern Utilities Investing Corporation*, Debtor, before a Special Master of the United States District Court for the District of Delaware, and which began after the conclusion of testimony in the public examination held by the Securities and Exchange Commission. Reference is also made to testimony in the income tax proceeding in the same matter.

<sup>2</sup> The Corporation was organized under the name of Eastern Hydro-Electric Company, which was subsequently changed to Pennsylvania Electric Corporation, then to Eastern Utility Preferred Holding Corporation and finally to Eastern Utilities Investing Corporation.

<sup>3</sup> These companies were Penn Public Service Corporation, Venango Public Service Corporation, Youghiogheny Hydro-Electric Corporation, Clarion River Power Corporation, Clarion Water Company, County Realty Company, and Penelec Water Company.

J. I. Mange (president and chairman of the board of directors of Associated Gas and Electric Company) was made vice president and director of Eastern Utilities Investing Corporation; John M. Daly (vice president of Associated Gas and Electric Company) and H. C. Hasbrouck (representative of Associated Gas and Electric Company) were made directors of Eastern Utilities Investing Corporation.

Although Eastern Utilities Investing Corporation was a separate corporate entity, the record establishes that it had virtually no existence independent of the Associated Gas & Electric System and was wholly and completely controlled by that "system" and its dominant personalities. Eastern Utilities Investing Corporation had no offices of its own and all the members of the board of directors and management consisted of individuals otherwise connected with the Associated Gas & Electric System. The investment company had no employees of its own, and all the work in connection with its affairs was handled by the employees of Mr. Hopson's personal companies.

The Associated Gas and Electric Company then almost immediately devised, and ultimately consummated, a plan whereby the Associated Gas and Electric Company would obtain from the Eastern Utilities Investing Corporation all the operating companies which had been transferred to it in 1924, and Eastern Utilities Investing Corporation would be given, in lieu of these operating companies, securities of the Associated Gas & Electric System.

Within six months after it assumed control of Eastern Utilities Investing Corporation, Associated Gas and Electric Company, in order to eliminate the minority interests held by the public in the Eastern Utilities Investing Corporation which still held the controlling blocks in the various operating companies, effected a plan of "reorganization" of the Eastern Utilities Investing Corporation. Associated Gas and Electric Company formed the Associated Electric Company. Associated Gas and Electric Company then caused its controlled subsidiary, Eastern Utilities Investing Corporation, whose board of directors consisted solely of Associated Gas and Electric Company men, to transfer control of the various operating companies, to the newly formed Associated Electric Company in consideration for the transfer to Eastern Utilities Investing Corporation of 242,700 shares of common stock of the Associated Electric Company.

As a result of this transaction, control of Eastern Utilities Investing Corporation's various operating companies was transferred to the newly formed Associated Electric Company, and in turn the Eastern Utilities Investing Corporation received 242,700 shares of common stock of Associated Electric Company, which continued to be all its outstanding common stock for only a short time, until it issued more for additional properties. These 242,700 shares of common of Associated Electric Company then constituted virtually the only asset of Eastern Utilities Investing Corporation. The plan of Associated Gas and Electric Company then was to obtain from Eastern Utilities Investing Corporation this controlling block of Associated Electric Company which now held the operating companies, so that Associated Gas and Electric Company would control Associated Electric Company, and the earnings from its operating companies would reach Associated Gas and Electric Company without going through Eastern Utilities Investing Corporation, in which there was a public interest.

One of the first steps taken by Associated Gas and Electric Company was to cause Associated Electric Company, now that it held the control of the operating companies, to issue \$65,000,000 of debentures. This issue of debentures of course was senior to the common stock which the Eastern Utilities Investing Corporation had received from the Associated Electric Company in exchange for the operating companies which it transferred to Associated Electric Company.

The next step in the plan was to cause the Eastern Utilities Investing Corporation to contract to transfer its holdings of 242,700 shares of common stock of Associated Electric Company to Associated Gas and Electric Company in exchange for 242,700 shares of the \$7 preferred stock of Associated Gas and Electric Company. By this transaction, Associated Gas and Electric Company was to obtain direct and complete control of Associated Electric Company, which in turn controlled the operating companies, and Eastern Utilities Investing Corporation, in lieu of its controlling block of Associated Electric Company, was to receive preferred stock of Associated Gas and Electric Company. Dissolution of Eastern Utilities Investing Corporation was then unsuccessfully attempted.

However, although Eastern Utilities Investing Corporation was caused to perform its obligations under the contract by delivering the 242,700 shares of common stock of Associated Electric Company to the Associated Gas and Electric

Company, the Associated Gas and Electric Company never delivered the 242,700 shares of its preferred stock. In fact, these shares of preferred stock were never issued, nor had they been authorized. Instead of delivering these 242,700 shares of preferred stock to Eastern Utilities Investing Corporation, Associated Gas and Electric Company merely gave Eastern Utilities Investing Corporation a contract obligation in the nature of a "due bill" to deliver these shares of preferred stock, and this "due bill" constituted virtually the sole asset of Eastern Utilities Investing Corporation for a year. Instead, the Eastern Utilities Investing Corporation, whose officers and directors consisted of Associated Gas and Electric Company men, accepted from Associated Gas and Electric Company a list of miscellaneous securities on or about July 31, 1927, just before the annual report for the year 1926 was to be sent to Eastern Utilities Investing Corporation stockholders. Thus, from July 1926 to July 31, 1927, the only substantial asset of Eastern Utilities Investing Corporation was the "due bill" for 242,700 shares of preferred stock of Associated Gas and Electric Company, and throughout this entire period the fact that this "due bill" constituted the only asset of Eastern Utilities Investing Corporation was never disclosed to stockholders.

The list of securities received by Eastern Utilities Investing Corporation in lieu of the preferred stock of Associated Gas and Electric Company called for by the "due bill" consisted almost entirely of securities of companies affiliated with the Associated Gas & Electric System, including securities of Public Utility Investing Corporation, Consumers Construction Company, Managing and Investing, Inc., Associated Electric Company, Associated Gas and Electric Company, and Gas and Electric Associates. Many of these securities had originally cost the Associated Gas and Electric Company virtually nothing, and others had been issued by companies in which Mr. Hopson was personally interested. Eastern Utilities Investing Corporation's transfer of the Associated Electric Company common stock to the Associated Gas and Electric Company and its acceptance of the "due bill" for Associated Gas and Electric Company preferred stock completed the first part of the plan of Associated Gas and Electric Company and these dominant personalities to obtain from Eastern Utilities Investing Corporation its operating companies and to make the public investors in Eastern Utilities Investing Corporation indirect holders of preferred stock of a holding company remote from the operating companies instead of stockholders in the company directly owning the operating companies. The stockholders in Eastern Utilities Investing Corporation became virtually indirect holders of the securities of the Associated Gas & Electric System and affiliated companies.

Eastern Utilities Investing Corporation was subsequently transformed into an investing company.

In March 1929 the investment company was caused to offer to the public, through Harris, Forbes & Company and Halsey, Stuart & Co., Inc., \$35,000,000 of its 5% gold debentures due 1954. The net proceeds from the sale of these debentures amounted to \$32,812,500. In the offering circular issued to the public describing this issue of debentures a representation was made:

"Eastern Utilities Investing Corporation (formerly Pennsylvania Electric Corporation) was organized in 1922 under the laws of the State of Delaware. It is engaged primarily in the business of acquiring and holding for long-term investment, securities deriving their income from public utility and allied enterprises. \* \* \* The corporation diversifies its investments among the securities of a number of public utility and allied enterprises."

The circular also set forth a list of 23 companies, which were claimed to be:

"Some of the more important companies, from whose general operations the dividend and interest income of the corporation is directly or indirectly derived." This circular did not list some of the larger investments made in affiliated companies of the Associated Gas & Electric System; it did not list the investment of \$8,400,000 in Gas and Electric Associates, another company affiliated with the "system," the investment of \$5,000,000 in Utility Management Corporation, or the investment of \$5,000,000 in Consumers Construction Company. On the other hand, the list included six well-known companies, such as Consolidated Gas Company of New York and Metropolitan Edison Company, in three of which companies Eastern Utilities Investing Corporation's investment was only approximately \$137,000, and in the remaining three of which it had no investment at all.

Eastern Utilities Investing Corporation never received the \$32,812,500 of cash proceeds from the sale of its debenture issue to the public. Instead, the



check received from the underwriters and investment bankers was immediately endorsed over to Associated Gas and Electric Company. Eastern Utilities Investing Corporation was again caused to accept blocks of stock of companies in the Associated System. Included in the securities so transferred were approximately \$26,500,000 of General Gas & Electric Corporation stock, approximately \$5,000,000 of Associated Gas and Electric Company stocks, and approximately \$1,200,000 of securities of subsidiaries of General Gas & Electric Corporation (which were almost immediately replaced by Associated Gas and Electric Company preferred stock). In lieu of \$32,812,500 of cash, which according to the representations made in the circular issued to the public was to be invested in diversified securities, Eastern Utilities Investing Corporation was compelled to accept securities of companies in the Associated System.

The final \$10,000,000 payment by Associated Gas and Electric Company on its purchase of control of General Gas & Electric Corporation, which itself had been loaded up by Associated Gas and Electric Company with securities of companies in its "system," was mostly made with cash traceable back to the \$32,812,500 cash received by Associated Gas and Electric Company from the sale of the Eastern Utilities Investing Corporation debentures. In turn, Eastern Utilities Investing Corporation was then loaded up with securities of the General Gas & Electric Corporation.

In addition, \$3,175,000 of the \$32,812,500 received by Associated Gas and Electric Company was used to carry on market operations in Associated Gas and Electric Company securities, some of which securities were then sold to the Eastern Utilities Investing Corporation at the resulting inflated prices.

As has been indicated, at the time Associated Gas and Electric Company took over control of Eastern Utilities Investing Corporation in 1925, the plant and property of the Eastern Utilities Investing Corporation and its subsidiaries amounted to approximately \$77,000,000. In addition, as has been indicated, \$35,000,000 of debentures of Eastern Utilities Investing Corporation had been sold to the public in March 1929, besides various other issues of its securities. Associated Gas & Electric System therefore had used Eastern Utilities Investing Corporation as a vehicle for taking over properties and raising cash, aggregating over \$112,000,000. As of December 31, 1929, even after the market decline of October 1929, Eastern Utilities Investing Corporation had assets valued by the management at approximately \$78,000,000. In October 1936, Eastern Utilities Investing Corporation was placed in receivership under Section 77b of the Bankruptcy Act, with assets valued by the management at approximately \$6,500,000, but which in fact had a market value of only \$1,500,000.

From 1925, when control was bought by Associated Gas and Electric Company, until the investment company went into 77b proceedings in bankruptcy in October 1936, the investment company never entered into a transaction involving the purchase, sale, or exchange of any substantial block of portfolio securities except with some Associated Gas & Electric System company. The prices at which the investment company acquired or disposed of securities were fixed by Henry A. Stix, comptroller of Eastern Utilities Investing Corporation and general auditor of Associated Gas and Electric Company, in compliance with the directions or policies of Mr. Hopson. As a result of such policies, the value of the portfolio of Eastern Utilities Investing Corporation shrank from \$2,200 per \$1,000 debenture in March 1929 to \$85 per \$1,000 debenture on May 12, 1933.

During the years 1929 and 1930 the total purchases of portfolio securities by Eastern Utilities Investing Corporation amounted to \$87,963,876 and \$50,198,829, respectively, and the sales amounted to \$59,558,892 and \$55,722,605, respectively. Despite the fact that the offering circular used in connection with the debentures stated that the holdings of the company were to be for long-term investments, the average turnover during these years was 75% per year, with a portfolio averaging approximately \$73,500,000.

Between June 1931 and October 1936 (when the company was put into receivership), various offers of exchange of Associated System securities for Eastern Utilities Investing Corporation securities had been made to the public and substantial amounts of outstanding securities of Eastern Utilities Investing Corporation had been reacquired by the "system." Although it is difficult to ascertain the precise loss sustained by investors in Eastern Utilities Investing Corporation, these losses were large and were sustained in connection with transactions which were effected between the Associated Gas and Electric Company and its subsidiaries and Eastern Utilities Investing Corporation, which was completely dominated by the Associated Gas and Electric Company personalities. Based on market prices as of December 31, 1935, debenture holders who made



the exchange had suffered losses of \$24,117,205 or over 72% of their original investment of \$33,385,660 and debenture holders who retained their debentures had suffered a loss of \$569,130 or 62% of their original investment of \$914,340.

In connection with these various exchange offers, material facts were concealed with respect to the financial condition of Eastern Utilities Investing Corporation, particularly with reference to default under the so-called "touch-off" clause in the indenture under which \$35,000,000 of the debentures were issued. That indenture required an asset coverage of 125% for the debentures outstanding which was not maintained. This default under the indenture was not only not disclosed to the security holders who were solicited to exchange their securities for Associated Gas and Electric Company securities, but communications to security holders carried the implication that no such default had occurred.

In furtherance of the plan to buy up the publicly held securities of the Eastern Utilities Investing Corporation, that investment company was placed in receivership in October 1936. The board of directors of Eastern Utilities Investing Corporation at that time was composed of employees of the Associated Gas & Electric System who subsequently resisted any attempts to have the court authorize any investigation of the company's transactions. This plan of reorganization submitted by the Associated System in connection with the receivership was merely a continuation of the exchange offers which had been previously made to the security holders of Eastern Utilities Investing Corporation. In essence the plan was an attempt to buy up the securities held by the remaining security holders, apparently in an effort to forestall any action against the Associated System and its officers and directors and to cover up the various transactions by liquidating the Eastern Utilities Investing Corporation.

Although annual audits were made of Eastern Utilities Investing Corporation, the serious condition of the company was not disclosed in published audits until after its debentures had defaulted in interest payment and asset coverage and the protective provisions of the indenture had been amended by the Associated Gas & Electric System through its vote of reacquired debentures in order to avoid enforcement of the default.

The debenture holders were not protected by the "protective provisions" of the indenture, which failed to require the trustee to take effective action on behalf of the debenture holders [in spite of having additional information indicating that the financial condition of the investment company was becoming increasingly serious]. The trustee for the holders of the \$35,000,000 principal amount of debentures took no effective steps throughout this period for the protection of the debenture holders and in the main relied on formal certificates filed by "representatives" of the system or of Mr. Hopson.

It is apparent that the entire history of the Eastern Utilities Investing Corporation from the time of acquisition of its control by the Associated Gas & Electric System and the H. C. Hopson interests was characterized by a complete subordination of the interests of the minority stockholders and the senior security holders to the interests of the "system" and Mr. Hopson. From its inception, the activities of Mr. Hopson, his associates and the "system" in connection with the Eastern Utilities Investing Corporation were apparently effected pursuant to a plan to strip the Eastern Utilities Investing Corporation of its operating companies and to use that investment company to raise funds, not for the benefit of its own security holders, but for the advancement of the interests of the "system" and H. C. Hopson.

## **B. Eastern Utilities Investing Corporation, Under Control of Walbridge & Co., Inc. (Before Acquisition by the Associated Gas & Electric System)**

### **1. INTRODUCTION**

Eastern Utilities Investing Corporation was organized on August 4, 1922, by H. D. Walbridge & Co., Inc. However, this report deals primarily with the history of Eastern Utilities Investing Corporation after September 1925, when control of this company was acquired by

the Associated Gas and Electric Company. All of its activities as an investment company occurred after Eastern Utilities Investing Corporation became a member of the "Associated System"<sup>4</sup> and was controlled by H. C. Hopson and J. I. Mange through Associated Gas & Electric Properties and Associated Gas and Electric Company and various other subsidiary and affiliated companies.<sup>5</sup>

The purchase of control of Eastern Utilities Investing Corporation added to the "System" certain gas and electric operating properties located in the western part of Pennsylvania and the northwestern part of Maryland. The magnitude and importance of this acquisition to Associated Gas and Electric Company are indicated by the fact that the approximately \$126,000,000 of total consolidated assets of Associated Gas and Electric Company was increased by at least 72% through the acquisition of the Eastern Utilities Investing Corporation, whose consolidated assets as at December 31, 1925, were reported to be \$91,160,676.<sup>6</sup> Similarly, the consolidated income statements<sup>7</sup> indicate that the gross revenues of Associated Gas and Electric Company on a consolidated basis were more than doubled by its acquisition of the Eastern Utilities Investing Corporation.

## 2. ORGANIZATION OF EASTERN UTILITIES INVESTING CORPORATION<sup>8</sup>

Eastern Utilities Investing Corporation was originally incorporated pursuant to the laws of the State of Delaware on August 4, 1922, under the name Eastern Hydro-Electric Company.<sup>9</sup> The company was sponsored and controlled by H. D. Walbridge & Company, Inc.,<sup>10</sup> and remained inactive, with only 10 shares of organization stock outstanding, until March 31, 1924. The name of the company was changed on March 20, 1924, from Eastern Hydro-Electric Company to Pennsylvania Electric Corporation.<sup>11</sup>

<sup>4</sup> Associated Gas & Electric System is referred to in this report as the "System" or as the "Associated System" and is intended to include Associated Gas & Electric Properties and its subsidiary and affiliated companies unless the context otherwise indicates.

<sup>5</sup> The two beneficial shares of Associated Gas & Electric Properties were held by Messrs. Hopson and Mange, respectively. For a brief description of the organization, control, and growth of the Associated Gas & Electric System, see Appendix G, p. 790 et seq. See also Appendix H (p. 798) showing ownership of voting stock of Eastern Utilities Investing Corporation.

<sup>6</sup> Public Examination, Eastern Utilities Investing Corporation, Commission's Exhibit No. 3815.

<sup>7</sup> Ibid. and report of the Federal Trade Commission on Utility Corporations, 1932, Senate Doc. 92, 70th Cong., 1st Sess., Part 45, p. 1586, and annual report of Pennsylvania Electric Corporation for the year ending December 31, 1925.

<sup>8</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3771, Part I, Item 1 (g).

<sup>9</sup> Because of the various names by which the Eastern Utilities Investing Corporation was known, the following table may be helpful in understanding the history of that corporation (op. cit. supra, note 6, Commission's Exhibit No. 3771, Part I, Item 1) :

Date name adopted :	Name adopted
Aug. 4, 1922-----	Eastern Hydro-Electric Company.
Mar. 20, 1924-----	Pennsylvania Electric Corporation.
Sept. 23, 1926-----	Eastern Utility Preferred Holding Corporation.
July 26, 1927-----	Eastern Utilities Investing Corporation.

<sup>10</sup> Op. cit. supra, note 6, at 23269.

<sup>11</sup> See note 9 supra.

On March 31, 1924, a majority or more of the common stocks of the following operating hydroelectric, coal, water, gas, and real estate companies were transferred to Pennsylvania Electric Corporation by H. D. Walbridge & Company, Inc.:<sup>12</sup>

Penn Public Service Corporation.  
Venango Public Service Corporation.  
Youghiougheny Hydro-Electric Corporation.  
Clarion River Power Corporation.  
Clarion Water Company.  
County Realty Company.  
Penelec Water Company.<sup>13</sup>

These operating companies became direct subsidiaries of Pennsylvania Electric Corporation (subsequently called Eastern Utilities Investing Corporation) and constituted practically its sole source of income. In consideration for the transfer to it of securities of these operating companies, the Pennsylvania Electric Corporation issued on the same day, March 31, 1924, to H. D. Walbridge & Company, Inc., 45,000 shares of its 7% preferred stock, 165,000 shares of its common stock,<sup>14</sup> and an option to purchase its debentures.<sup>15</sup> Also on March 31, 1924, upon the exercise of this option, Pennsylvania Electric Corporation issued and sold to H. D. Walbridge & Company, Inc., \$5,000,000 principal amount of 30-year 6½% sinking fund gold debentures, receiving therefor certain convertible notes of two of its new subsidiaries and a comparatively small amount of cash.<sup>16</sup>

The securities so received by Pennsylvania Electric Corporation (subsequently Eastern Utilities Investing Corporation) had a par or face value of \$10,464,475, but were placed on the books at a cost of \$26,097,659 on the basis of \$25,384,750 of its securities issued and \$712,909 cash paid therefor.<sup>17</sup>

The consolidated balance sheet of Pennsylvania Electric Corporation (subsequently Eastern Utilities Investing Corporation) at December 31, 1924, showed that these subsidiaries thus acquired by Pennsylvania Electric Corporation had plant and property amounting to \$76,932,015, and the consolidated income statement for that year showed gross revenues of \$8,935,246, and net income of \$1,509,394 after making deductions for depreciation reserves.<sup>18</sup>

At that time (at the end of 1924), the public held \$39,514,700 of bonds and over \$10,000,000 of stocks of these subsidiary companies. In addition, Pennsylvania Electric Corporation itself had outstanding \$4,969,000 principal amount of 6½% debentures due 1954, 44,090¾ shares of \$100 par 7% cumulative preferred stock, and 159,756¾ shares of no-par common stock.<sup>19</sup>

<sup>12</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3772, Items 45 and 46.

<sup>13</sup> Id., at 23269-70; 23277.

<sup>14</sup> 5254¾ shares of the common stock and 922 shares of the preferred stock of Pennsylvania Electric Corporation were returned to its treasury as a result of the nondelivery by H. D. Walbridge & Company, Inc., of certain stock covered by the agreement. (Id., Commission's Exhibit No. 3772, Item 45, p. 2.)

<sup>15</sup> Id., Commission's Exhibit No. 3772, Items 45 and 46.

<sup>16</sup> Id., Commission's Exhibit No. 3772, Item 45.

<sup>17</sup> Ibid. The cash included \$10,408.84 for revenue stamps.

<sup>18</sup> Id., Exhibit G to Mr. Stix's testimony.

<sup>19</sup> Ibid.

## C. Eastern Utilities Investing Corporation Becomes a Subsidiary of the Associated Gas and Electric Company

### 1. CONTRACT OF PURCHASE OF CONTROL BY ASSOCIATED GAS AND ELECTRIC COMPANY

On June 4, 1925, H. D. Walbridge & Company, Inc., contracted to sell, and Associated Gas and Electric Company, to buy, all the stocks owned by the seller, or interests affiliated with it,<sup>20</sup> of Pennsylvania Electric Corporation (subsequently Eastern Utilities Investing Corporation), which at this time owned, aside from any cash, only the securities of the operating companies heretofore enumerated. Prior to this contract, Associated Gas and Electric Company held no interest in Pennsylvania Electric Corporation.<sup>21</sup>

In March 1925 the funded debt of Pennsylvania Electric Corporation had been increased by the issuance of \$2,500,000 principal amount of 6% debentures<sup>22</sup> so that the company's securities outstanding at June 4, 1925, were:<sup>23</sup>

	Held by public		Held by Walbridge		Total
	Amount	Percent	Amount	Percent	
Shares of common stock .....	46,507	29	114,611	71	161,118
Shares of preferred stock .....	20,328	46	24,019	54	44,347
Principal amount of debentures <sup>24</sup> .....	\$7,437,500	100	-----	-----	\$7,437,500

In the contract of sale, H. D. Walbridge & Company, Inc., stated on behalf of itself and associates that it owned and offered to sell and deliver not less than 24,019 shares or 54% of the outstanding preferred stock and 114,610.68 shares or 71% of the outstanding common stock of Pennsylvania Electric Corporation.

By the terms of the contract, the purchase price was \$100 for each share of common stock and \$95 plus accrued dividends for each share of preferred stock.<sup>25</sup> This cash was payable \$20 per share upon acceptance, \$20 per share plus interest at the closing date, and the balance within one year thereafter.<sup>26</sup> Apparently this cash was ob-

<sup>20</sup> The contract was evidenced by a letter containing an offer made by H. D. Walbridge & Company, Inc., which letter was signed in acceptance by H. C. Hopson, vice president, and M. C. O'Keefe, secretary of Associated Gas and Electric Company. (Id., Commission's Exhibit No. 3772, Items 51 and 52.)

<sup>21</sup> Id., at 23269.

<sup>22</sup> Id., Commission's Exhibit No. 3772, Item 52, page 13.

<sup>23</sup> Id., Commission's Exhibit No. 3772, Items 51 and 52.

<sup>24</sup> This is as of May 31, 1925. (Id., Commission's Exhibit No. 3772, Item 54.)

<sup>25</sup> Id., Commission's Exhibit No. 3772, Item 51. The contract also provided for the sale of participating stock of a Pennsylvania Electric Corporation subsidiary named Clarion River Power Co. at \$50 a share.

<sup>26</sup> "The balance of the purchase price, in cash, one year from August 1, 1925, subject to extension as provided in the annexed form of escrow agreement, such payment to be secured by your one year promissory note or notes aggregating in principal amount the amount of such balance, bearing interest, payable quarterly, at the rate of 7% per annum from July 1, 1925, on such portion of the principal amount thereof as equals the balance of the purchase price of the preferred stock of the Pennsylvania Company, and at the rate of 6% per annum from August 1, 1925, on the remaining portion of the principal amount thereof, secured by pledge of all of said shares of stock". (Ibid.)

tained by Associated Gas and Electric Company's issuing 6½% interest-bearing option warrants.<sup>27</sup> The contract further required Associated Gas and Electric Company to make the same offer to the public holders of Pennsylvania Electric Corporation's (subsequently Eastern Utilities Investing Corporation) securities. Although such offers were made, they were complicated by three simultaneous and alternative offers of securities of Associated Gas and Electric Company.<sup>28</sup>

## 2. NEW DIRECTORS IDENTIFIED WITH ASSOCIATED GAS AND ELECTRIC COMPANY

Formal control of the Pennsylvania Electric Corporation (later Eastern Utilities Investing Corporation) was taken by Associated Gas and Electric Company on September 23, 1925, and the composition of the board of directors was immediately changed.<sup>29</sup> H. C. Hopson, J. I. Mange, John M. Daly, and H. C. Hasbrouck became directors of Pennsylvania Electric Corporation. J. I. Mange became its president and H. C. Hopson, a vice president.<sup>30</sup>

Mr. Mange was president and chairman of the board of directors and Mr. Hopson was vice president, treasurer, and a director of Associated Gas and Electric Company. They were also officers of Associated Securities Corporation; trustees, directors, and officers of Associated Gas & Electric Properties,<sup>31</sup> through which companies they held control of Associated Gas and Electric Company and of Eastern Utilities Investing Corporation,<sup>32</sup> and officers and directors of other subsidiaries of Associated Gas and Electric Company.<sup>33</sup>

John M. Daly was vice president of Associated Gas and Electric Company, and H. C. Hasbrouck also represented Associated Gas and Electric Company.<sup>34</sup>

## 3. EASTERN UTILITIES INVESTING CORPORATION CONTROLLED BY ASSOCIATED GAS AND ELECTRIC COMPANY

Since 1925, when Associated Gas and Electric Company first purchased control<sup>35</sup> of Pennsylvania Electric Corporation (subsequently Eastern Utilities Investing Corporation), the policies and affairs of

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<sup>27</sup> Report of the Federal Trade Commission on Utility Corporations, 1932 (Senate Document 92, 70th Cong., 1st Sess.), Part 45, pp. 1308-12.

<sup>28</sup> *Op. cit. supra*, note 6, Commission's Exhibit No. 3823. Offers to common stockholders were made on August 24, 1925, January 25, 1926, and August 4, 1926. Offers to preferred holders were made August 25, 1926, and April 20, 1926. See *infra*, pp. 639-40 and note 81.

<sup>29</sup> *Op. cit. supra*, note 6, at 23277.

<sup>30</sup> *Id.*, at 23278-9. In 1927, Mr. Hopson became president and remained in that office until June 1933 when he was succeeded by a subordinate. Mr. Hopson also became treasurer in 1926. (*Id.*, Commission's Exhibit No. 3832.)

<sup>31</sup> *Id.*, at 23280.

<sup>32</sup> *Id.*, at 23279 et seq.

<sup>33</sup> *Id.*, at 23280.

<sup>34</sup> *Id.*, at 23281.

<sup>35</sup> *Id.*, at 23271-2, 23277.

this Corporation have been dominated and controlled by the management of Associated Gas and Electric Company.<sup>36</sup>

Although Eastern Utilities Investing Corporation had a separate corporate charter<sup>37</sup> and owned at December 31, 1929, investments carried at \$78,207,157,<sup>38</sup> it nevertheless completely lacked independence, having no office of its own, no clerical staff, and no independent management. Mr. Bowman, a partner of Haskins & Sells which, beginning in 1929, certified the financial statements of Eastern Utilities Investing Corporation, testified concerning that corporation:<sup>39</sup>

A. It [Eastern Utilities Investing Corporation] did not have a separate and distinct set of employees from the employees of the Associated [Gas & Electric] System. That is about the only difference that I could see.

Q. And it didn't have a separate office?

A. I believe not.

Q. And all of its acquisitions of securities were from within the "System"?

A. Well, I should say that they made most of their acquisitions through securities companies of the Associated [Gas & Electric] System.

Q. If you were asked to describe the way Eastern Utilities Investment Corporation was operated, what statement would you make?

A. I would say that it was an investment company, and its accounts were kept like any investment company, instead of having a separate clerical organization who devoted its time entirely to this company, the clerical services and management was performed by people connected with the Associated [Gas and Electric] Company.

Q. And its financial transactions were all handled through the Associated System?

A. I believe that is a fair statement.

Q. And it paid its taxes through the Associated System, did it not?

A. I believe so.

Mr. Bowman further testified:<sup>40</sup>

Q. Could you go to any one place and say that that room was the office of Eastern Utilities Investing Corporation and not the office of any other company?

A. No; I think their office was in the Associated [Gas & Electric] System.

Q. That is, the employees who would work on Eastern Utilities Investing Corporation matters were employees of Hopson's service companies or other companies in the Associated [Gas & Electric] System?

A. That is right.

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<sup>36</sup> See, as to:

(a) Stock control—*infra*, p. 635, and Appendix H, p. 798; *op. cit. supra*, note 6, at 23279, and Commission's Exhibit No. 3772, Item 5.

(b) Management by service companies—Appendix G, p. 790 *et seq.*; see also *infra*, pp. 635 and 702.

(c) Interlocking officers and directors—*infra*, p. 636; see also Report of the Federal Trade Commission on the Relation of Holding Companies and Operating Companies in Power and Gas Affecting Control, 73d Cong., 2d Sess., House Report 827, Part I, p. 275 under H. C. Hopson, p. 354 under J. I. Mange.

(d) All transactions involving purchase or sale of securities being exclusively with "System" companies—*infra*, p. 634 and Mr. Stix's testimony, *op. cit. supra*, note 6, at 25779-80.

<sup>37</sup> Certificate of incorporation filed August 4, 1922, with the Secretary of State of the State of Delaware under the name of Eastern Hydro-Electric Company. (*Op. cit. supra*, note 6, Commission's Exhibit No. 3771, Part I, which also contains amendments thereto.)

<sup>38</sup> *Id.*, Commission's Exhibit No. 3771, Part I.

<sup>39</sup> *Id.*, at 24328-9.

<sup>40</sup> *Id.*, at 24326-7.

Mr. Stix, formerly comptroller of Eastern Utilities Investing Corporation and general auditor for Associated Gas and Electric Company,<sup>41</sup> and recently made vice president and comptroller of Associated Gas and Electric Company,<sup>42</sup> testified:<sup>43</sup>

Q. By the end of 1926, control of Eastern Utilities Preferred Holding Company rested with Associated Gas & Electric Properties, did it not?

\* \* \* \* \*

A. Yes.

Q. And Associated Gas & Electric Properties held that control through Associated Securities Corporation and Associated Gas and Electric Company and subsidiaries; isn't that right?

A. No; it held the control through Associated Securities Corporation and Associated Public Utilities Corporation.

Q. And Associated Gas & Electric Properties was owned one-half by Mr. H. C. Hopson, who was an officer of Eastern Utilities Investing Corporation, and one-half by Mr. J. I. Mange; isn't that right?

A. That is my understanding.

After being made part of the "Associated Gas & Electric System," Eastern Utilities Investing Corporation was caused to transact all purchases and sales of its portfolio securities with "System" companies.<sup>44</sup> Its affairs were controlled by those controlling the Associated Gas and Electric Company,<sup>45</sup> and its business was conducted by employees of Mr. Hopson's service companies.<sup>46</sup> It did not have its own employees<sup>47</sup> or office.<sup>48</sup> It paid service fees for management as well as for a clerical organization. As Mr. Stix testified:<sup>49</sup>

Q. So that the persons whom Mr. Hopson employed to render services in his business would naturally become officers and directors of a company like Eastern Utilities Investing Corporation which was being serviced?

<sup>41</sup> Op. cit. supra, note 6, at 23257-9.

<sup>42</sup> *In the matter of Associated Gas and Electric Company*, S. E. C. Docket 1-1810. Hearing on April 27, 1939, Rec. pp. 277-8.

<sup>43</sup> *Id.*, at 23321. See also *In the United States District Court for the District of Delaware, In the Matter of Eastern Utilities Investing Corporation*, debtor, No. 1247, in Reorganization Tax Proceedings before William Prickett as Special Master, where Mr. Stix testified (*id.*, at 1108):

Q. Now the Eastern Utilities Investing Corporation, Mr. Stix, was that a corporation which was in any measure independent of Associated Gas and Electric Company or was it wholly controlled by the management of Associated Gas and Electric Company?

A. It was wholly controlled by the Associated management.

Q. Then I take it the Associated management kept its books and made its investments for it. Is that true?

A. I think that would be a fair statement.

<sup>44</sup> Op. cit. supra, note 6, at 24326-9 and 25779-80, and Commission's Exhibit No. 3771, Part VII, Schedules 32 and 33.

<sup>45</sup> See supra, pp. 632-3.

<sup>46</sup> Mr. Bowman testified (op. cit. supra, note 6, at 24331):

Q. Well, it is pretty clear, isn't it, most of the services rendered to Eastern Utilities Investing Corporation were rendered by persons connected with the Associated System or Hopson Companies?

A. Yes, that is pretty clear. (See also *infra*, pp. 635-8 and Appendix G, p. 790 et seq.)

<sup>47</sup> *Id.*, Commission's Exhibit No. 3771, Part IV, Item 16.

<sup>48</sup> *In the United States District Court for the District of Delaware, In the matter of Eastern Utilities Investing Corporation*, debtor, in proceedings for the reorganization of a corporation pursuant to Section 77B of the Bankruptcy Act as amended No. 1247 in Bankruptcy. Transcript of proceedings before William Prickett as Special Master to conduct a 21A examination and to report to the court the testimony taken and evidence received, pp. 28-9.

<sup>49</sup> Op. cit. supra, note 6, at 24788.

A. Yes, in conjunction with performing the service that had to be performed for Eastern Utilities Investing Corporation, some of them had to become officers.

Q. Was that because rendering services as officers was part of the services they were rendering as employees of these service organizations?

A. Yes; there had to be people to sign papers and things of that kind.

As one of its own officials testified when explaining why it was unnecessary to pay rent for Eastern Utilities Investing Corporation:<sup>50</sup>

Q. Just a set of books was kept as part of the general bookkeeping system of the Associated?

A. Yes.

#### 4. H. C. HOPSON-DOMINATED COMPANIES SERVICED EASTERN UTILITIES INVESTING CORPORATION

Having no independent management of its own, Eastern Utilities Investing Corporation was managed by individuals who were employees of various of the service companies which were under the control of H. C. Hopson.<sup>51</sup> This management function was performed by H. C. Hopson and Company up to 1932, thereafter by Utility Auditors and Tax Consultants,<sup>52</sup> another Hopson service company.

Mr. Stix testified:<sup>53</sup>

Q. And H. C. Hopson and Company rendered services to Eastern Utilities Investing Corporation?

A. Yes.

Q. What kind of services?

A. Well, it kept the books and the minute books; it safeguarded the securities; it bought securities and sold securities for them.

Q. It rendered all of the services, did it not, that the management of the company ordinarily renders?

A. Yes.

#### 5. SERVICE CHARGES OF SUBSIDIARIES

On September 23, 1925, Associated Gas and Electric Company took complete control of Pennsylvania Electric Corporation by filling the board of directors of the Pennsylvania Electric Corporation with its representatives. This control was then used to effect a preference for the controlling interest through the exaction of service fees.<sup>54</sup>

The controlling interest caused Pennsylvania Electric Corporation to cause its operating subsidiaries to enter into servicing contracts with Associated Gas and Electric Company by the terms of which

<sup>50</sup> Op. cit. supra, note 46, p. 162. See also infra.

<sup>51</sup> See Appendix G, p. 790 et seq.

<sup>52</sup> Mr. Stix testified (op. cit. supra, note 6, at 24771):

Q. When the servicing of Eastern Utilities Investing Corporation was taken over by Utility Auditors and Tax Consultants, did H. C. Hopson and Company cease to render service to Eastern Utilities Investing Corporation?

A. Yes.

Q. And that was in 1932?

A. Yes.

<sup>53</sup> Id., at 24763.

<sup>54</sup> Id., at 23282-7.



21½% of gross revenues was to be paid for management services and 7½% of additions to fixed capital was to be paid for services in connection with construction.<sup>55</sup>

The effect of this was to create charges payable to the controlling interest ranking ahead of dividends payable to the minority interests in the stock of Pennsylvania Electric Corporation and its subsidiaries and in this way to siphon funds to Associated Gas and Electric Company.<sup>56</sup>

In addition, the operating subsidiaries of Pennsylvania Electric Corporation paid service charges to service companies organized and run by H. C. Hopson.<sup>57</sup>

The servicing of Pennsylvania Electric Corporation and its operating subsidiaries had been performed by H. D. Walbridge & Company, Inc., prior to the time that Associated Gas and Electric Company bought control.<sup>58</sup> However, immediately after this transfer of control Pennsylvania Electric Corporation caused its subsidiary operating companies to enter into a contract, dated November 12, 1925, whereby these subsidiaries were obligated to pay to Pennsylvania Electric Corporation fees for those services which had been rendered to these subsidiaries from May 1, 1924, to September 22, 1925<sup>59</sup> (the period when Walbridge & Co. was in control and had rendered the services), at the same rate at which future services were to be rendered<sup>60</sup> by Associated Gas and Electric Company.<sup>61</sup>

As has been indicated, the board of directors of Pennsylvania Electric Corporation was composed of directors and officers of the Associated Gas and Electric Company or its affiliates. Associated Gas and Electric Company owned most of the stock of Pennsylvania Electric Corporation.<sup>62</sup> Thus, the payments made by subsidiaries to Pennsylvania Electric Corporation for services theretofore rendered by H. D. Walbridge & Company, Inc., formed the basis of dividends

<sup>55</sup> Id., Commission's Exhibit No. 3803.

<sup>56</sup> See *infra*, p. 637.

<sup>57</sup> The Federal Power Commission has instituted an inquiry "to determine the extent to which H. C. Hopson and others exercised dominance and control over \* \* \* six utilities and exacted from them so-called service charges, as well as the reasonableness of such charges." See Federal Power Commission Release No. 717, dated February 8, 1939, which lists the six utilities as follows:

Metropolitan Edison Company.  
Northern Pennsylvania Power Company.  
Pennsylvania Electric Company.  
Erie Lighting Company.  
The Clarion River Power Company.  
Solar Electric Company.

Of these, Pennsylvania Electric Company and The Clarion River Power Company hold properties formerly held by subsidiaries of Pennsylvania Electric Corporation (subsequently called Eastern Utilities Investing Corporation).

<sup>58</sup> *Op. cit. supra*, note 6, at 23282.

<sup>59</sup> Id., at 23283.

<sup>60</sup> Id., at 23286.

<sup>61</sup> Mr. Stix testified (*id.*, at 23286-7):

Q. What was the rate at which the subsidiaries of Eastern Utilities Investing Corporation, then Pennsylvania Electric Company, were to pay service charges to Eastern Utilities Investing Corporation?

A. 2½ percent of the gross for management services and 7½ percent of additions to fixed capital for construction fees.

Q. And that was at the same rate provided in the contract being made with the Associated Gas and Electric Company for services?

A. That is correct.

<sup>62</sup> Id., at 23283-4.

which Associated Gas and Electric Company caused Pennsylvania Electric Corporation to declare<sup>63</sup> and which were paid principally to Associated Gas and Electric Company.<sup>64</sup> By this arrangement, Associated Gas and Electric Company made use of its controlling position to require the operating subsidiaries of Pennsylvania Electric Corporation to pay service charges ahead of interest and dividends on their own securities, some of which were held by the public. When examined on the question, Mr. Stix testified:<sup>65</sup>

Q. So that payments that would be made for services to Eastern Utilities Investing Corporation would form the basis of dividends which could be declared to Associated Gas and Electric Company?

A. That is correct.

Q. Now had these services to the subsidiaries of Eastern Utilities Investing Corporation been paid for prior to November 12, 1925?

A. No; as I understand it, the services had been rendered by H. D. Walbridge & Company but not paid for by Pennsylvania Electric Corporation or its subsidiaries.

Q. So that Pennsylvania Electric Corporation—that is, Eastern Utilities Investing Corporation—was causing its subsidiaries to pay to it service charges for services rendered by H. D. Walbridge & Company; is that right?

A. That is right. That was part of the understanding in connection with the acquisition by Associated Gas and Electric Company.

Q. Was that done by written contract, was that contained in the written contract between H. D. Walbridge & Company and Associated Gas and Electric Company?

A. I don't think so.

Mr. Stix further said:<sup>66</sup>

A. On November 12, 1925, a contract was entered into between Associated Gas and Electric and the subsidiaries of Eastern Utilities Investing Corporation effective as of September 23, 1925. At the same time Eastern Utilities Investing Corporation arranged for payment to it of charges for services for the period from May 1, 1924, to September 22, 1925.

Q. And at the time that action was taken the Board of Eastern Utilities Investing Corporation was controlled by Associated Gas and Electric Company?

A. Yes, sir.

Although these fees were to be paid to Pennsylvania Electric Corporation for services rendered by H. D. Walbridge & Company, Inc., allegedly as part of an understanding in connection with the acquisition by Associated Gas and Electric Company, nevertheless that part of the understanding was not evidenced by any writing. H. D. Walbridge & Company, Inc. was completely out of the picture at the time that this obligation to pay for these past services was placed on the operating companies.<sup>67</sup> Mr. Stix agreed that:<sup>68</sup>

<sup>63</sup> Dividends paid on the 7% preferred stock of Pennsylvania Electric Corporation (subsequently Eastern Utilities Investing Corporation) for 1924, 1925, and 1926 were respectively \$231,202.00, \$379,218.29, and \$497,315.59. (Id., Commission's Exhibit No. 3772, Item 48.)

<sup>64</sup> Id., Commission's Exhibits No. 3815 and No. 3816.

<sup>65</sup> Id., at 23284.

<sup>66</sup> Id., at 23283.

<sup>67</sup> Id., at 23284-5.

<sup>68</sup> Id., at 23285-6.

\* \* \* the requirement that the subsidiaries of Pennsylvania Electric Corporation pay the service charges added additional cost to the operating expenses of those subsidiaries, \* \* \* to the extent that they represented charges for management service of companies which were actually in operation at that time. \* \* \* And to the extent that the service charges were paid for capital additions, they would be added to the property account \* \* \*. In any event, it would add charges ahead of dividends payable to minority interests \* \* \*.

The contract to pay Associated Gas and Electric Company for future services had the same effect with respect to minority interest except that since these service fees did not go through Pennsylvania Electric Corporation (subsequently Eastern Utilities Investing Corporation), but directly to Associated Gas and Electric Company or its assigns, the minority security holders of Pennsylvania Electric Corporation were also short-circuited.<sup>69</sup>

## 6. NEW TRANSFER AGENTS AND DEPOSITORIES

Other powers incident to control of the investment company were also immediately utilized. On September 23, 1925, at the suggestion of H. C. Hopson, the National Bank of Commerce in New York and The Chase National Bank of the City of New York were chosen as depositories and the New York Trust Company was made depository for the funds of the investment company.<sup>70</sup>

## 7. EASTERN UTILITIES INVESTING CORPORATION CAUSED TO BUY PREFERRED STOCK OF ITS PARENT

On November 12, 1925, Pennsylvania Electric Corporation (subsequently Eastern Utilities Investing Corporation) authorized and issued 4,610 shares of its 7% preferred stock (\$100 par) to the controlling interest, Associated Gas and Electric Company, in exchange for the same number of shares of \$7 preferred stock of Associated Gas and Electric Company.

This transaction was effected, it was claimed, in order to round out the outstanding number of preferred shares of Pennsylvania Electric

<sup>69</sup> *Id.*, at 23397-8. As will be discussed in more detail *infra*, Associated Gas and Electric Company assigned the right to collect fees under these contracts to two of its subsidiary service companies (Consumers Construction Company and Managing and Investing, Inc.) in which it later caused Eastern Utilities Investing Corporation to invest \$10,000,000. (See *infra*, pp. 654-61.) For that \$10,000,000, Eastern Utilities Investing Corporation acquired preferred stocks of these companies which had as their only asset the service contracts with former subsidiaries of Eastern Utilities Investing Corporation and other operating companies. These subsidiary service companies did not do the actual servicing, which was let out to others. In other words, a part of the investment of Eastern Utilities Investing Corporation was in service companies which held the service contracts with operating subsidiaries of Associated Gas and Electric Company, some of which were acquired from Eastern Utilities Investing Corporation. These contracts were included among the service contracts which, although they had been acquired by the Associated Gas & Electric System without the expenditure of any cash or property had been assigned by Associated Gas and Electric Company to the subsidiary service companies for more than \$28,000,000 in stock and notes of these service companies and were capitalized at the same amount. (Op. cit. *supra*, note 7, Part 46, pp. 245-9.)

<sup>70</sup> Op. cit. *supra*, note 6, at 23282. The New York Trust Company subsequently became trustee for \$35,000,000 of the company's debentures. (*Ibid.*) For detailed discussion of this trustee's activities in connection with these debentures, see *infra*, p. 690.

Corporation to 75,000.<sup>71</sup> However, a large amount of outstanding securities intervened between Associated Gas and Electric Company preferred stock and the operating properties in its system, whereas Pennsylvania Electric Corporation directly held the securities of the operating companies and so was only one step removed from their properties. Consequently, this so-called rounding out process resulted in the subsidiary receiving from its parent a stock much further removed from the ultimate source of income than was the stock which it gave to its parent in exchange. In addition, some circular ownership between the parent and the subsidiary was created by this transaction.<sup>72</sup> Moreover, the Pennsylvania Electric Corporation 7% preferred stock was a security which had a much better ratio of income to dividend requirements than the Associated Gas and Electric Company \$7 preferred stock possessed.<sup>73</sup>

## 8. EFFORT TO REMOVE PUBLIC INTEREST FROM EASTERN UTILITIES INVESTING CORPORATION

The general financial policy of Associated Gas and Electric Company formulated by Mr. Hopson was to reduce to a minimum the publicly owned securities of subsidiaries through offers to exchange therefor securities of the parent company and otherwise.<sup>74</sup> Pursuant to this policy, the Associated Gas and Electric Company caused the Pennsylvania Electric Corporation (subsequently Eastern Utilities Investing Corporation) to call and pay off its debentures,<sup>75</sup> and made an effort to acquire the publicly-held common stock of Pennsylvania Electric Corporation publicly held by sending to the public stockholders on August 24, 1925, January 25, 1926, and August 4, 1926,<sup>76</sup> letters over the signature of H. C. Hopson, containing different offers to exchange various securities of Associated Gas and Electric Company for the common stock of Pennsylvania Electric Corporation. In order to comply with a requirement of the contract for purchase of control from Walbridge, these letters also offered cash payable in installments over a year's time.<sup>77</sup> Apparently as a result of these various offers, the public holding of 46,507 shares of common stock on June 4, 1925,<sup>78</sup> was reduced to

<sup>71</sup> Op. cit. supra, note 6, at 23287-8.

<sup>72</sup> Id., at 23288.

<sup>73</sup> Id., at 23314. Mr. Stix when examined on this exchange testified (id., at 23288) :

Q. Why was Associated preferred put in the Eastern Utilities Investing Corporation portfolio rather than something else?

A. Oh, I don't know. I guess we thought that was probably as good as anything else that might be put in.

Q. That was Eastern Utilities Investing Corporation owning stock in its parent company, is that right?

A. Yes, sir.

<sup>74</sup> Id., at 25031-40. Also see Report of this Commission on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Part VII, May 10, 1938, Section II.

<sup>75</sup> Op. cit. supra, note 6, at 23272 and Commission's Exhibit No. 3772, Item 60.

<sup>76</sup> Id., Commission's Exhibit No. 3823. In the January 25, 1926, letter, Associated Gas and Electric Company claimed to have acquired over 95% of the common stock; and in its August 4, 1926, letter, over 99% of the common stock.

<sup>77</sup> Id., at 23290-1.

<sup>78</sup> See supra, pp. 631-2, *Contract of Purchase of Control by Associated Gas and Electric Company*.

about 10,000 shares as at December 31, 1925, to about 4,000 shares by October 1926,<sup>79</sup> and to 1,256 shares by December 31, 1927.<sup>80</sup>

Under date of August 25, 1925, Associated Gas and Electric Company offered to the public holders of the preferred stock of Pennsylvania Electric Corporation four alternative exchange offers.<sup>81</sup>

A condition of both offers made in August 1925 was that the public security holder agree not to dispose of the securities received by him from Associated Gas and Electric Company before January 1, 1926, a little over four months after the dates of the offers.<sup>82</sup>

The broad variety of options available to the preferred stockholder of Pennsylvania Electric Corporation was evidently designed to attract holders with varying investment points of view. Moreover, on April 20, 1926, in an entirely different role and capacity, Mr. Hopson, as vice president of Pennsylvania Electric Corporation, in a letter purporting to give investment advice, encouraged the preferred stockholders to accept the exchange offers:<sup>83</sup>

I am taking the liberty of calling your attention to what we consider a desirable exchange offer, subject to withdrawal without notice, made by Associated Gas and Electric Company \* \* \*.

\* \* \* \* \*

For additional information in connection with this exchange offer, do not hesitate to inquire of us, as the Customer Ownership Department is prepared to assist you in any matter at all times.

Very truly yours,

(Signed) H. C. HOPSON,

*Vice President.*

Despite the intensive effort of the Associated Gas and Electric Company to induce these exchanges, the public still retained, on December 31, 1927, 15,337 shares of the preferred stock of Eastern Utilities Investing Corporation<sup>84</sup> as compared with 20,328 shares of preferred stock held by the public on June 4, 1925.

<sup>79</sup> Op. cit. supra, note 6, at 23291.

<sup>80</sup> Id., Commission's Exhibit No. 3772, Item 6.

<sup>81</sup> These offers were in substance as follows:

1. Associated Gas and Electric Company 6½% Interest Bearing Option Warrants as follows:

(a) Three such warrants, each \$35 paid, for (1) One share of preferred stock, plus (2) \$10 in cash; or

(b) Two such warrants, each \$35, paid, and \$20 cash for one share of preferred stock, or

(c) One such warrant, \$95 paid, for one share of preferred stock.

2. For each ten shares of preferred stock, \$1,000 principal amount of Associated Gas and Electric Company 6% Convertible Debenture Bonds and one share of Associated Gas and Electric Company Class A stock.

3. For each ten shares of 7% preferred stock, 10 shares of Associated Gas and Electric Company \$6.50 Dividend Series Preferred Stock and 2 shares of Associated Gas and Electric Company Class A stock.

4. For each share of preferred stock, \$95 cash, payable 40% on October 1, 1925, the balance on Oct. 1, 1926, or earlier, such delayed payment being secured by 6% promissory notes.

Id., Commission's Exhibit No. 3823. These alternative offers were presented on the letterhead of Associated Gas and Electric Company over the signature of H. C. Hopson as vice president and treasurer.

<sup>82</sup> Ibid. This condition would obviously aid the Associated Gas & Electric System in maintaining the attractiveness of the stock marketwise, which would have been more difficult if the Associated Gas and Electric Company securities offered in exchange were immediately offered by the public for sale on the market.

<sup>83</sup> Id., Commission's Exhibit No. 3823.

<sup>84</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3772, Item 6.

## D. Shift of Operating Companies from Eastern Utilities Investing Corporation To Associated Electric Company, Another Subsidiary of Associated Gas and Electric Company

### 1. FORMATION AND PURPOSE OF ASSOCIATED ELECTRIC COMPANY

Having failed to eliminate the minority interest directly held by the public in Pennsylvania Electric Corporation, there was what Mr. Stix<sup>85</sup> characterized as "a reorganization."<sup>86</sup> This "reorganization" was effected in the spring of 1926 and was consummated by the formation by Associated Gas and Electric Company of a new company—the Associated Electric Company—to which were transferred the operating subsidiaries of Pennsylvania Electric Corporation (subsequently Eastern Utilities Investing Corporation).

The management of Associated Gas and Electric Company, through control of Pennsylvania Electric Corporation and of this new company, Associated Electric Company, stripped the Pennsylvania Electric Corporation of its operating companies which constituted practically its sole source of income.<sup>87</sup> This stripping was accomplished through several steps.

### 2. TRANSFER OF OPERATING COMPANIES AND EFFECT THEREOF

Pursuant to action of its board of directors, composed of Associated System representatives, Pennsylvania Electric Corporation, on April 8, 1926,<sup>88</sup> transferred its assets to Associated Electric Company in exchange for 242,700 shares (all of the issued and outstanding shares) of common stock of this newly formed company.<sup>89</sup> Pennsylvania Electric Corporation's debentures were retired as a prerequisite to the release of its operating company stocks from the indenture.<sup>90</sup> In connection with the sale of these assets to Associated Electric Company, Pennsylvania Electric Corporation was placed in funds to enable it to redeem its outstanding debentures<sup>91</sup> which were then redeemable at 105.<sup>92</sup>

<sup>85</sup> General Auditor for Associated Gas and Electric Company and Comptroller of Eastern Utilities Investing Corporation, recently promoted to Vice-President and Comptroller of Associated Gas and Electric Company. (Op. cit. supra, note 6, at 23257-9; and *In the Matter of Associated Gas and Electric Company*, S. E. C. Docket 1-1810, Hearing on April 27, 1939, at pp. 277-8.)

<sup>86</sup> Op. cit. supra, note 6, at 23291-2.

<sup>87</sup> Ibid. For the influence of the investment bankers in this "reorganization," see infra, p. 645, *Banker Participation in the "Reorganization."*

<sup>88</sup> Derived from supplementary information supplied the Commission for Eastern Utilities Investing Corporation. (Minutes of meeting of board of directors of Eastern Utilities Investing Corporation held on April 8, 1926.)

<sup>89</sup> Op. cit. supra, note 6, at 23292.

<sup>90</sup> Id., Commission's Exhibit No. 3776. Mr. Stix testified (id., at 23272):

Q. When Associated Gas and Electric Company acquired that stock [of Eastern Utilities Investing Corporation from H. D. Walbridge & Company, Inc.], Pennsylvania Electric Corporation had certain debentures outstanding, did it not?

A. It did.

Q. Do you remember the amount of those debentures outstanding?

A. It seems to me it was about 3½ million.

Q. Were they retired?

A. Yes; they were called and paid off in 1926.

<sup>91</sup> Id., Commission's Exhibit No. 3816. Mr. Stix explained that Associated Electric Company assumed the debentures of Pennsylvania Electric Corporation.

<sup>92</sup> Id., Commission's Exhibit No. 3776, p. 35.

It was claimed that the transfer of these operating companies to Associated Electric Company was part of a plan to merge this newly formed company with Pennsylvania Electric Corporation after the former company had acquired certain additional operating companies.<sup>93</sup> However, after Associated Electric Company actually did acquire these other operating companies, this alleged plan of merger was never effected. No reason was advanced for the abandonment of the plan of merger, but the operating companies were not returned to Pennsylvania Electric Corporation.

Mr. Stix, formerly Auditor and now Comptroller of Associated Gas and Electric Company,<sup>94</sup> testified:<sup>95</sup>

Q. And was it the original plan that Associated Electric Company would be merged into Eastern Utilities Investing Corporation then called Pennsylvania Electric Corporation after Associated Electric Company had acquired certain additional properties?

A. I think it was.

Q. But that plan was abandoned?

A. It was abandoned.

Q. What was the reason for the abandonment of that plan?

A. I never knew. I never could understand. Never could understand what they were trying to do.

\* \* \* \* \*

Q. Was he [Mr. Burroughs]<sup>96</sup> active in the transactions which resulted in these exchanges?

A. I think he was largely the originator of the idea of forming the Associated Electric Company.

Mr. Stix further testified:<sup>97</sup>

Q. Who besides Mr. Burroughs took part in the transactions whereby Eastern Utilities Investing Corporation transferred stocks in its subsidiaries to Associated Electric Company and Associated Electric Company issued its common stock to Eastern Utilities Investing Corporation?

A. Mr. Hopson, Mr. Daly, and a whole flock of lawyers.

Q. What firms were represented in connection with that transaction?

A. Legal firms you mean?

Q. Yes.

A. For the company there was Travis, Brownback, and whatever other names there were I don't recall now.

Q. By the company, you mean Associated Gas and Electric Company?

A. Yes, sir.

Q. And that law firm has been counsel for the same interest ever since?

A. Yes, sir.

This first transfer inserted a new company between Pennsylvania Electric Corporation and its operating companies, the original source of its income. Associated Electric Company controlled the oper-

<sup>93</sup> Id., at 23292.

<sup>94</sup> Op. cit. supra, note 6, at 23257-9; and *In the Matter of Associated Gas and Electric Company*, S. E. C. Docket 1-1810, Hearing on April 27, 1939, Rec. pp. 277-8.

<sup>95</sup> Op. cit. supra, note 6, at 23292-3.

<sup>96</sup> Partner of Harris, Forbes & Company, Director of Associated Gas and Electric Company and Associated Electric Company. (Id., Commission's Exhibit No. 23293 and 3832.) See infra, p. 645, *Banker Participation in the "Reorganization."*

<sup>97</sup> Op. cit. supra, note 6, at 23295-6.

ating companies and Pennsylvania Electric Corporation, through its ownership of all the outstanding securities, controlled Associated Electric Company. However, Associated Electric Company soon issued additional common stock for other properties,<sup>98</sup> thereby reducing Pennsylvania Electric Corporation's control over its former properties and putting its security holders into investments as far distant as the Philippine Islands. Although Pennsylvania Electric Corporation was given an equity in a larger utility system, it was not allowed to keep this equity for any appreciable period of time since, as will be indicated below, Associated Gas and Electric Company caused its subsidiary, Pennsylvania Electric Corporation, to turn over to the parent the controlling block of Associated Electric Company stock.

Furthermore, Associated Electric Company issued and sold to the public \$65,000,000 principal amount of debentures,<sup>99</sup> the underlying assets of which included all of the operating properties previously controlled by Pennsylvania Electric Corporation. These debentures, of course, ranked ahead of the Associated Electric Company common stock which had been issued to Pennsylvania Electric Corporation in consideration for those properties.

Mr. Stix, when examined on the effect of the issuance of these debentures, testified:<sup>100</sup>

Q. Associated Electric Company issued \$65,000,000 of debentures which you mentioned earlier; right?

A. Yes.

Q. And upon this transaction the preferred holders of Pennsylvania Electric Corporation were one step further removed from operating properties than they had been?

A. They were removed from the operating properties. I don't know whether one or more steps, but at least one.

On July 1, 1926,<sup>101</sup> Pennsylvania Electric Corporation conveyed all of its holdings of the common stock of Associated Electric Company to its parent, Associated Gas and Electric Company, thereby relinquishing control over utility operating companies it formerly controlled, in consideration for the promise of the parent to deliver to Pennsylvania Electric Corporation 242,700 shares of \$7 preferred stock of Associated Gas and Electric Company.<sup>102</sup> This \$7 preferred stock had a preference on involuntary liquidation of \$24,270,000 and constituted a part of a total of \$42,974,060<sup>103</sup> of Associated Gas and Electric Company preferred stocks which were junior to any of Pennsylvania Electric Corporation's previous holdings. In fact, these transactions inserted between Pennsylvania Electric Corporation's former properties and the stockholders of Pennsylvania Electric Corporation the following additional securities: \$65,000,000

<sup>98</sup> Id., at 23292.

<sup>99</sup> Id., at 23308.

<sup>100</sup> Ibid.

<sup>101</sup> Id., at 23311, 24677 and Commission's Exhibit No. 3804.

<sup>102</sup> Id., at 23296-8. The "due bill," signed by Associated Gas and Electric Company, by which it agreed to deliver 242,700 shares of its preferred stock was practically Eastern Utilities Investing Corporation's only asset for a year. (Id., at 24676-7.)

<sup>103</sup> Report of the Federal Trade Commission on Utility Corporations, 1932, Senate Doc. 92, 70th Cong., 1st Sess., Part 45, p. 1467, indicates the capitalization as at December 31, 1926.



Associated Electric Company new debentures,<sup>104</sup> and \$12,182,200 Associated Gas and Electric Company funded debt.<sup>105</sup>

However, the 242,700 shares of preferred stock of Associated Gas and Electric Company which Pennsylvania Electric Corporation was to receive on this exchange not only were never delivered<sup>106</sup> but were never authorized and never issued.<sup>107</sup> Instead, the Pennsylvania Electric Corporation received the promise, or a "due bill," from the Associated Gas and Electric Company to deliver these shares of preferred stock.

Mr. Stix, when examined on this exchange, testified:<sup>108</sup>

Q. What actually happened was that after Eastern Utilities Investing Corporation, then Pennsylvania Electric Corporation, had acquired the common stock of Associated Electric Company in the amount of 242,700 shares, it exchanged that stock for preferred stock of Associated Gas and Electric Company; is that right?

A. That is correct.

Q. That was \$7 preferred?

A. It was.

Q. And the 242,700 shares of Associated Electric Company common stock went to Associated Gas and Electric Company?

A. Yes, sir.

Q. Were the shares of Associated Gas and Electric Company preferred stock actually delivered to Eastern Utilities Investing Corporation, or was a due bill given?

A. I think they gave a due bill.

Q. For the purpose of the record would you describe just what a due bill is and who issues and who signs it?

A. A due bill is either a typewritten or a printed promise on the part of a corporation or individual to deliver the securities described in the promise.

\* \* \* \* \*

Q. What is the purpose of issuing a due bill rather than the shares of stock?

A. Why, I think it was to save original issue stamps.

Q. Are you advised as to the legal right the holder of a due bill has to call on the issuer of the due bill for delivery of the stock?

A. It has always been my understanding that the holder of a due bill has the same right as the holder of a certificate.

\* \* \* \* \*

Q. Is a due bill ever issued for stock not yet authorized?

A. Yes; if you control the common stock so that you can cause it to be authorized at any time.

Pennsylvania Electric Corporation (subsequently Eastern Utilities Investing Corporation) held this due bill calling for the delivery of these 242,700 shares for over a year.<sup>109</sup> However, dividends were paid on the shares called for by this due bill although these shares were not issued or authorized.<sup>110</sup> Ultimately, as will be indicated in detail,

<sup>104</sup> Op. cit. supra, note 6, at 23308.

<sup>105</sup> Op. cit. supra, note 103, Part 45, p. 1467.

<sup>106</sup> See infra, pp. 648-50, *Release of Due Bill*.

<sup>107</sup> Op. cit. supra, note 6, at 24676-7 and see infra, p. 648. An amount equal to the dividend was paid although the stock was not authorized or issued. (Id., at 23298-9.)

<sup>108</sup> Op. cit. supra, note 6, at 23296-8.

<sup>109</sup> Id., at 24676-7.

<sup>110</sup> Id., at 23299, 24676-7.

Pennsylvania Electric Corporation received, in lieu of the preferred stock of Associated Gas and Electric Company, a basket of miscellaneous securities of companies of the Associated System.

### 3. BANKER PARTICIPATION IN THE "REORGANIZATION"

The plan of Associated Electric Company, about April 1926, to issue \$65,000,000 in principal amount of its debentures, the largest public utility debenture issue offered to the public up to that time, was formulated by F. S. Burroughs, a senior partner of Harris, Forbes & Company.<sup>111</sup> About one-half of the assets behind the debentures had been acquired from Pennsylvania Electric Corporation during the early part of April 1926 in the manner described above. Harris, Forbes & Company underwrote the issue.<sup>112</sup> At the same time, Harris, Forbes & Company was retained as financial advisor to the Associated Gas & Electric System and received 50,000 shares of common stock of Associated Gas and Electric Company as a bonus or retainer. In connection with the Associated Electric Company financing, Mr. Burroughs and C. W. Beall, another Harris Forbes partner, were made directors of Associated Gas and Electric Company, and Mr. Burroughs and H. M. Addinsell, a third Harris Forbes partner, went on the Board of Associated Electric Company.<sup>113</sup>

So that commencing about April 1926 the bankers, Harris, Forbes & Company, were retained as financial advisers and began to take an active part in planning the Associated Gas & Electric System's expansion program.

### 4. DELAYED AND INADEQUATE DISCLOSURE

Although the original transaction by which the operating properties were shifted from Pennsylvania Electric Corporation to Asso-

<sup>111</sup> Id., at 23293 and 23440. Harris, Forbes & Company and Harris Trust and Savings Bank of Chicago were founded by N. W. Harris. Harris, Forbes & Company was a New York corporation formed before the New York Law required that the name of a corporation disclose that it was a corporation. It was "an offshoot of the old N. W. Harris & Company," as were the other Harris Forbes companies. There were no outside interests in any of these Harris Forbes Companies. (Id., at 23505-8. See also id., at 23448-52, 27116-7, and Commission's Exhibit No. 3845 (d).) For a further discussion see *infra*, p. 501. *General Investment Corporation*, note 3.

<sup>112</sup> The Federal Trade Commission report states that the gross profit to the bankers was \$10 per \$100 principal amount, but Mr. Burroughs testified that his recollection was that the spread was only \$4.50 or \$5.00 per \$100. (Id., at 26905, 26912, 23440-2, and *op. cit. supra*, note 103, Part 46, p. 791.)

<sup>113</sup> Mr. Burroughs testified (*op. cit. supra*, note 6, at 23445-6):

A. \* \* \* At about that time [i. e., time of financing of Associated Electric Company] Associated [Gas and Electric Company] was anxious to have the banking and financial advice of Harris Forbes people, and Mr. C. W. Beall and myself went on the Board of Associated Gas and Electric Company, and Mr. H. M. Addinsell and I went on the Board of Associated Electric Company. We received 50,000 shares, I think, of common stock of Associated Gas and Electric Company, but you may be sure it was not considered as being in connection with that deal because we did not pass any of it on to the other people in that financing, although they knew all about it.

Q. Harris Forbes received 50,000 shares?

A. Yes, sir.

Q. Not you as [an] individual partner?

A. No. They received it largely for the work which I and the organization immediately associated with me had done and were to continue to do. The idea was they [Associated Gas and Electric Company] wanted our [Harris, Forbes & Company] help in building up Associated Gas & Electric System. It was not uncommon although it was becoming less common to give bonuses of stock in companies when you were undertaking a sponsorship.

ciated Electric Company for 242,700 shares of Associated Electric Company common stock was authorized on April 8, 1926,<sup>114</sup> the stockholders of Eastern Utilities Investing Corporation (formerly Pennsylvania Electric Corporation) received more than a year and a quarter later the first intimation that it had been caused to dispose of its operating company securities. The only statement in H. C. Hopson's letter of August 5, 1927, to the stockholders of Eastern Utilities Investing Corporation relating to this transaction was:<sup>115</sup>

During the year 1926 the Company received a favorable offer to dispose of its entire holdings in the control of certain corporations operating in Pennsylvania and Maryland. The directors of the company considered this opportunity a desirable one and accepted it.

This statement by the president to the stockholders failed to disclose that the Eastern Utilities Investing Corporation had disposed of all its operating companies to Associated Electric Company, another subsidiary of Associated Gas and Electric Company; failed to disclose that the consideration for this transfer of the operating companies had been the delivery to the Company of 242,700 shares of common stock of Associated Electric Company; failed to disclose that these shares of common stock had been transferred to Associated Gas and Electric Company in consideration of a "due bill" for 242,700 shares of Associated Gas and Electric Company preferred stock; and failed to disclose that delivery of the preferred shares under this due bill had never been made. This letter did not contain any intimation that in the interim period, from July 1 1926<sup>116</sup> to July 31, 1927 (almost to the very date of this statement made by the president on August 5, 1927), the portfolio of Eastern Utilities Investing Corporation had consisted solely, or almost solely, of a due bill for 242,700 shares of preferred stock of Associated Gas and Electric Company. Mr. Stix testified:<sup>117</sup>

Q. So that Eastern Utilities Investing Corporation held a promise from Associated Gas and Electric to deliver to Eastern Utilities Investing Corporation \$24,270,000 par value of preferred stock?

A. That is correct.

Q. And that was Eastern Utilities Investing Corporation's only asset at the time?

A. Yes, sir.

Q. And to get that asset it had conveyed the stocks in its seven subsidiaries?

A. Yes, sir.

Nor was the public advised that the Associated Gas and Electric Company throughout the year had neither authorized nor issued the shares called for by the due bill.<sup>118</sup>

<sup>114</sup> About 6 months after Associated Gas and Electric Company had acquired formal control of Pennsylvania Electric Corporation (subsequently Eastern Utilities Investing Corporation). Derived from supplementary information supplied the Commission for Eastern Utilities Investing Corporation. (Minutes of Meeting of Board of Directors of Eastern Utilities Investing Corporation, April 8, 1926.)

<sup>115</sup> Op. cit. supra, note 6. Commission's Exhibit No. 3816 and at 24689.

<sup>116</sup> Id., at 23311, 24677 and Commission's Exhibit No. 3804.

<sup>117</sup> Id., at 23300.

<sup>118</sup> Id., Commission's Exhibit No. 3816.

With the president's letter and as part of the annual report of Eastern Utilities Investing Corporation went the accompanying "balance sheet at December 31, 1926" which merely stated on the "asset's side":<sup>119</sup>

Stocks owned and receivable under contracts-----	\$24, 885, 505. 48
Accounts receivable-----	612, 444. 00
Total-----	25, 497, 949. 48

Since at least \$24,270,000 of "stocks owned and receivable under contracts" represented stock of Associated Gas and Electric Company, to be delivered under the due bill, "stocks owned" could not at the most have been more than \$615,505.48. The lumping of "stocks receivable under contracts" with "stocks owned" not only failed to disclose the large amount of securities which were merely receivable pursuant to the due bill, but also had the effect of giving the erroneous impression that the item "stocks receivable under contracts" was no larger than would ordinarily exist in the regular course of business.

## 5. NO ARM'S-LENGTH DEALING TO PROTECT MINORITY

Pennsylvania Electric Corporation's transfer of its operating companies to Associated Electric Company for the common stock of the latter company and the subsequent acceptance by the Pennsylvania Electric Corporation for this common stock of a due bill for Associated Gas and Electric Company preferred stock was effected by boards of directors of these companies (Associated Gas and Electric Company, Pennsylvania Electric Corporation, and Associated Electric Company),<sup>120</sup> consisting almost entirely of the same individuals. Mr. Stix testified:<sup>121</sup>

Q. In effect the Boards of the three companies were under the same control, isn't that right?

A. Well, they were almost all the same people.

## 6. PROPOSALS NOT SUBMITTED AT ANY STOCK-HOLDERS' MEETING

These transactions were not submitted for approval at any stockholders' meeting. As previously noted, not even an announcement of the transactions was made until long after their consummation. Mr. Stix testified:<sup>122</sup>

Q. The minority stockholders, preferred stockholders, and common stockholders of Eastern Utilities Investing Corporation were several steps further removed from the operating properties after exchange for the Associated Gas and Electric Company preferred stock?

A. They were.

Q. And the consent of those minority stockholders was not obtained to change the company from a direct holding company to a holding company several steps removed from operating properties, was it?

<sup>119</sup> Ibid.

<sup>120</sup> Op. cit. supra, note 6, at 23309.

<sup>121</sup> Id., at 23310.

<sup>122</sup> Id., at 23317 and 24691.

A. I don't recall that the minority voted for or against it, and I don't recall that they did vote.

\* \* \* \* \*

Q. \* \* \* but it is fair to say that since you have not been able to find a record of a vote by stockholders of Eastern Utilities Investing Corporation with respect to the exchange of Associated Electric Company common stock for the due bill that there was no such vote.

A. Yes.

## 7. FAILURE TO DISCLOSE SHIFT IN INVESTORS' POSITION

Since the portfolio of Pennsylvania Electric Corporation consisted almost only of the "due bill," the public investors in that Corporation were in essence made indirect investors in Associated Gas and Electric Company. Yet these investors had no means of ascertaining that fact since no public disclosure was made that the portfolio of Pennsylvania Electric Corporation consisted only of the due bill. The prior refusal of these public stockholders to surrender their Pennsylvania Electric Corporation securities in exchange for Associated Gas and Electric Company securities was, by this due bill transaction, substantially negated and frustrated. The public stockholder was made to do indirectly that which he refused to do directly—to exchange his interest in the properties underlying the Pennsylvania Electric Corporation for an interest in Associated Gas and Electric Company.

## 8. RELEASE OF DUE BILL

On August 1, 1927, the officers of Eastern Utilities Investing Corporation, without the formality of a resolution of its board of directors, released Associated Gas and Electric Company from its obligation to deliver 242,700 shares of Associated Gas and Electric Company \$7 Dividend Series preferred stock, pursuant to the terms of the due bill, which was the only, or almost the only, security in Eastern Utilities Investing Corporation's portfolio, and accepted in lieu thereof a basket of miscellaneous securities.<sup>123</sup>

This transaction was consummated just before the issuance on August 5, 1927, of the annual report of Eastern Utilities Investing Corporation for the year 1926 and the letter of Mr. Hopson to stockholders, which omitted all reference to this due bill.

Moreover, in his letter Mr. Hopson asserted:<sup>124</sup>

As you have been informed by separate communications, the name of your Company was changed to Eastern Utility Preferred Holding Corporation and thereafter to its present and more suitable one of Eastern Utilities Investing Corporation, and its holdings of investments have also been considerably diversified. The acquisition of these investments was made possible by new financing, which has been explained in the various letters to you.

This statement accompanying the 1926 report was susceptible of the construction that the diversification of the portfolio was increased

<sup>123</sup> See *supra*, pp. 641-5. *Transfer of Operating Properties and Effect Thereof*, and note 130, *infra*.

<sup>124</sup> *Op. cit. supra*, note 6. Commission's Exhibit No. 3816.

over the portfolio of the company shown in the report for 1925,<sup>125</sup> consisting of the various operating companies. Technically, by accepting the list of miscellaneous securities in lieu of the due bill which practically constituted the entire portfolio of the Company, the diversification was increased.<sup>126</sup>

Neither the officers' action on August 1, 1927, of exchanging the due bill for the miscellaneous investments nor the corporation's metamorphosis into an investing company by such exchange was authorized or ratified by its board of directors until one year later, July 24, 1928.<sup>127</sup>

The resolution of the board<sup>128</sup> consists of more than a ratification of the prior act of the officers of Eastern Utilities Investing Corpo-

<sup>125</sup> Id., Commission's Exhibit No. 3815.

<sup>126</sup> It will be recalled that the stockholders had not been informed of the fact that the portfolio of the company consisted virtually only of this due bill.

<sup>127</sup> The members of the board, in addition to Mr. Hopson, as shown in the Annual Report were:

John I. Mange (held joint control of the "System" with Hopson).

Garrett A. Brownback (a "System" lawyer, now a senior partner of the "System" firm of Travis, Brownback & Paxson).

Fred S. Burroughs (then a partner of Harris, Forbes & Company, "System" bankers and a director of Associated Gas and Electric Company, and since 1932 an assistant to Hopson and vice president of Associated Gas and Electric Company).

John M. Daly (also vice president of Associated Gas and Electric Company and an assistant to Hopson).

Warren Partridge ("an old Walbridge man" who had been made vice president of New England Gas and Electric Association, a subsidiary of Hopson and Mange's Associated Gas & Electric Properties. Although Warren Partridge is no longer connected with the "System," his son, also named Warren Partridge, is still connected with the "System").

(Op. cit. supra, note 6, at 23468, Commission's Exhibits No. 3771, Part I, and No. 3775. See also Appendix G (p. 790 et seq.) for J. I. Mange's joint control of the "System.")

<sup>128</sup> The Board of Directors' minute entry under date of July 24, 1928, reads as follows (op. cit. supra, note 6, Commission's Exhibit No. 3804): "The President reported to the meeting that under date of July 1, 1926, this Corporation (then known as 'Pennsylvania Electric Corporation') sold and delivered to Associated Gas and Electric Company 242,700 of no par stock of Associated Electric Company, said Associated Gas and Electric Company agreeing to deliver to this Corporation in consideration therefor a like number of shares of its \$7 Dividend Series Preferred Stock; that said Associated Gas and Electric Company, with the consent and approval of this Corporation delivered to this Corporation in lieu of said shares of its \$7 Dividend Series Preferred Stock various securities of public utility operating and holding companies, which, in the opinion of both parties, were at least equal in value to the value of said shares of \$7 Dividend Series Preferred Stock, and that under date of August 1, 1927, this Corporation acknowledged payment in full by Associated Gas and Electric Company of its obligations under said agreement with this Corporation dated July 1, 1926.

"Upon motion duly made, seconded, and unanimously carried, it was: *Resolved*, That the action of the officers of this Corporation in executing under date of August 1, 1927, and furnishing to Associated Gas and Electric Company, an acknowledgement of payment in full by said Associated Gas and Electric Company of its obligations under said agreement with this Corporation dated July 1, 1926, and release from all liability thereunder, be and hereby is approved, ratified, and confirmed."

Apparently in an attempt to give substance to the releasing language, the fiction of arm's-length bargaining was created by the recital that "*in the opinion of both parties*," the consideration received was at least equal to that released. The action, however, to accomplish this was taken by the same persons, H. C. Hopson, F. S. Burroughs, John M. Daly, Warren Partridge, who represented both Associated Gas and Electric Company and Eastern Utilities Investing Corporation so that in effect Associated Gas and Electric Company was attempting to release itself from any claims.

ration in accepting the list of miscellaneous securities in lieu of the preferred stock of Associated Gas and Electric Company called for by the due bill. The resolution also attempts to release Associated Gas and Electric Company from all liability in connection with the transaction of July 1, 1926, whereby Associated Gas and Electric Company caused Pennsylvania Electric Corporation to sell its holdings of the common stock of Associated Electric Company to the Associated Gas and Electric Company.<sup>129</sup>

## 9. SECURITIES RECEIVED FROM ASSOCIATED GAS AND ELECTRIC COMPANY IN LIEU OF DUE BILL

On July 31, 1927, Eastern Utilities Investing Corporation surrendered to the Associated Gas and Electric Company the due bill for 242,700 shares of Associated Gas and Electric Company preferred stock and delivered 75,000 shares of its own \$5.50 prior preference stock in exchange for a list of miscellaneous securities<sup>130</sup> with an

<sup>129</sup> It will be recalled that Pennsylvania Electric Corporation (subsequently Eastern Utilities Investing Corporation) had controlled the operating companies through the Associated Electric Company.

<sup>130</sup> *List of securities transferred to Eastern Utilities Investing Corporation, July 31, 1937: a*

	Shares	Transfer price	Transfer value
Amesbury Elec. Lt. Co., common.....	800	60½	\$48,400
Amesbury Elec. Lt. Co., V. T. C., common.....	660	59	38,940
Central Mass. Lt. & Pr. Co. V. T. C., #1, common.....	1,566	134	209,844
Central Mass. Lt. & Pr. Co. V. T. C. #2, common.....	108	100	10,800
Central Mass. Lt. & Pr. Co. V. T. C. #2, pref.....	5,504	107	588,928
Central Mass. Pr. Co., pref.....	56	101	5,656
Central Mass. Pr. Co. V. T. C., common.....	17	70	1,190
Commonwealth Gas & Elec. Cos., pref.....	429	99	42,471
Franklin County Power Co., pref.....	67	101	6,767
Franklin County Power Co., V. T. C., common.....	39	46	1,794
Marlboro Elec. Co., common.....	195	245	47,775
Mass. Lighting Cos., common.....	11,539	148	1,707,772
Mass. Lighting Cos., 6% pref.....	1,451	117	169,767
Mass. Lighting Cos., 8% pref.....	490	137	67,130
Merrimac Valley Pr. & Bldg. Co., 7% pref.....	140	112½	15,750
New Hampshire Pr. Co., 8% pref.....	395	98	38,710
Norwood Gas Co., common.....	33	100	3,300
Old Colony Lt. & Pr. Assoc., pref.....	246	101	24,846
Old Colony Lt. & Pr. Assoc., common.....	910	52½ (sic)	54,990
Paul Smiths Elec. Lt., Pr., & R. R. Co., common.....	500	400	200,000
Pittsfield Elec. Co., common.....	583	399	232,617
Plymouth Elec. Lt. Co., common.....	69	215	14,835
Plymouth Elec. Lt. Co. V. T. C., common.....	80	215	17,200
Randolph & Holbrook Pr. & Elec. Co., common.....	9	45	405
S. Eastern Mass. Pr. & Elec. Co., common.....	561	76	42,636
S. Eastern Mass. Pr. & Elec. Co., V. T. C., common.....	747	70	52,290
So. Berkshire Pr. & Elec. Co., common.....	1,650	70	115,500
Weymouth Lt. & Pr. Co. V. T. C., common.....	85	58	20,764
Weymouth Lt. & Pr. Co., common.....	1,616	60	96,960
Winchendon Elec. Lt. & Pr. Co., common.....	85	140	11,900
Worcester Suburban Elec. Co., common.....	1,974	102	201,348
Worcester Suburban Elec. Co., V. T. C., common.....	934	98	91,532
Erie Lighting Co., pref.....	1,000	33½	33,500
Indiana Gas Util. Co., 7% pref.....	1,000	100	100,000
Long Island Water Corp., 6% pref.....	1,000	100	100,000
Staten Island Edison Corp., 6% pref.....	1,000	100¾	100,750
Assoc. Gas & Elec. Co., class A.....	75,000	40	3,000,000
Assoc. Gas & Elec. Co., \$6 debent.....	\$4,000,000	95	3,800,000
Consumers Const. Co., 7% pref.....	50,000	100	5,000,000
Managing & Inv., Inc., 7% pref.....	50,000	100	5,000,000
Gas & Elec. Assoc., 7% pref.....	75,000	100	7,500,000
Pub. Utility Inv. Corp., 7% pref.....	10,000	100	1,000,000
Assoc. Elec. Co., 5½% bonds.....	\$2,050,000	100½	2,060,250
Assoc. Gas & Elec. Co., \$7 pref.....	26,000	100	2,600,000
Total.....			34,477,317

<sup>a</sup> Op. cit supra, note 6, Commission's Exhibit No. 3772, Item 2.

<sup>b</sup> Principal amount.

assigned value of \$34,477,317.<sup>131</sup> By this transaction the securities of about 24 companies were put into the portfolio of Eastern Utilities Investing Corporation.<sup>132</sup> However, of the total of these securities, \$29,960,250, or over 91% of the assigned value, was allocated to blocks of securities of the following six companies subject to Hopson's dominating influence: Public Utility Investing Corporation, Consumers Construction Company, Managing and Investing, Inc., Associated Electric Company, Associated Gas and Electric Company, and Gas and Electric Associates.<sup>133</sup>

Each of these six blocks of securities will be discussed in some detail hereafter. The discussion of various aspects of these investments may indicate the motives which prompted their transfer to Eastern Utilities Investing Corporation. Mr. Hopson was president, treasurer, and director<sup>134</sup> of and had a substantial interest in Public Utility Investing Corporation which was largely supervised by him personally.<sup>135</sup> The other five companies were direct or indirect subsidiaries of Associated Gas & Electric Properties.<sup>136</sup> No market quotations apparently existed for any of the six securities except for those of Associated Gas and Electric Company and Associated Electric Company. Described briefly, Public Utility Investing Corporation was primarily Hopson's investment company; Consumer's Construction Company and Managing and Investing, Inc., had no assets except management contracts with controlled companies, and the capitalization of these contracts had been entirely dictated by the management of Associated Gas and Electric Company; Associated Electric Company had control of the operating properties formerly controlled by Eastern Utilities Investing Corporation; Associated Gas and Electric Company controlled Eastern Utilities Investing Corporation, which in turn acquired securities of this parent;<sup>137</sup> the acquisition of Gas and Electric Associates securities was tantamount to a loan to Messrs. Hopson and Mange.<sup>138</sup>

The capitalization of service contracts held by Consumer's Construction Company and Managing and Investing, Inc., accounted for more than \$10,000,000 of the \$28,000,000 of capitalization created by Associated Gas and Electric Company by valuation of service contracts held by subsidiaries.<sup>139</sup>

When examined as to the basis of selection of the securities for the portfolio switch of July 31, 1927, Mr. Stix testified:<sup>140</sup>

<sup>131</sup> Op. cit. supra, note 6, at 23355-9 and Commission's Exhibit No. 3772, Item 2.

<sup>132</sup> Id., at 23358.

<sup>133</sup> Id., at 23359 and Commission's Exhibit No. 3772, Item 2.

<sup>134</sup> Id., at 23377 and 23385.

<sup>135</sup> Id., at 23360.

<sup>136</sup> Id., at 23359.

<sup>137</sup> From "November 1927 (as of August 1927)" until March 1932, Associated Gas and Electric Company held an option to reacquire at cost the Eastern Utilities Investing Corporation Class B (voting) stock which Associated Gas and Electric Company transferred to Eastern Utilities Investing Trust, another subsidiary of Associated Gas & Electric Properties. (Id., at 23346-8 and Appendix II, p. 798.) Mr. Stix testified as follows (op. cit. supra, note 6, at 23347):

Q. While Associated Gas and Electric Company held that option on Class B stock but had not exercised it, it had the power to control Eastern Utilities Investing Corporation?

A. Yes, sir.

<sup>138</sup> See infra, p. 661.

<sup>139</sup> See supra, p. 638, note 69, and op. cit. supra, note 103, Part 46, pp. 245-9.

<sup>140</sup> Op. cit. supra, note 6, at 23389 and 23375.



Q. Did you make up the list of securities that Eastern Utilities Investing Corporation was to receive as part of the exchange at July 31, 1927?

A. Yes.

Q. At whose direction was that list made up?

A. As I recall either at the direction of Mr. Daly or Mr. Hopson.

Concerning Mr. Daly, Mr. Stix testified:<sup>141</sup>

Q. Was Mr. Daly an assistant to Mr. Hopson at that time?

A. Yes.

Q. What was his title?

A. Vice president of Associated Gas and Electric Company.

Q. And at that time he was in very close contact with Mr. Hopson?

A. Yes.

Q. Did you often receive instructions through Mr. Daly from Mr. Hopson?

A. I did, and he probably received them from Mr. Hopson through me.

Mr. Stix further testified:<sup>142</sup>

A. \* \* \* I think I was told to find what securities of the "System" were available and give the company as diversified a portfolio as I could figure it out.

Q. All the securities in the list were at that time owned by the "System," were they not?

A. I think so; yes. There might have been some few exceptions, but I don't believe very many.

Q. And those exceptions would be very minor in terms of dollar amounts?

A. Very minor, if there were any at all.

It is patent that the securities transferred to Eastern Utilities Investing Corporation in lieu of the Associated Gas and Electric Company preferred stock called for by the "due bill," consisted of securities which the "System" had on hand and primarily of securities of companies of the "System." It was a list of securities the composition of which in no small measure was dictated not by investment quality but by availability to the controlling company. Eastern Utilities Investing Corporation commenced its investing-company career with a transaction by which its parent caused the investment company to acquire from its parent almost \$34,500,000 of securities "selected" by Mr. Hopson, who was in control of both parent and subsidiary—a list of securities whose "diversification" was determined by Mr. Hopson and by the availability of these securities for sale by the "System."<sup>143</sup>

#### a. Public Utility Investing Corporation

Included in the list of securities acquired by Eastern Utilities Investing Corporation on July 31, 1927, were 10,000 shares of the preferred stock of Public Utility Investing Corporation at an aggregate cost to the investment company of \$1,000,000.<sup>144</sup> Mr. Stix testified:<sup>145</sup>

Q. Could you say you had no conversations with Mr. Hopson with respect to this exchange of July 31, 1927?

A. Oh, no; I talked it over with him. I talked it over with a lot of people.

<sup>141</sup> Id., at 23376.

<sup>142</sup> Id., at 23376-7.

<sup>143</sup> Ibid.

<sup>144</sup> Id., Commission's Exhibit No. 3772, Item 2.

<sup>145</sup> Id., at 23373-4.

Q. Mr. Hopson advising the exchange should be made?

A. No: this transaction we are speaking about came about by my making up a list of various kinds of securities which were in the Associated System, or which could be acquired and were considered to be good investments by Eastern Utilities Investing Corporation. Then I presented the list to various officers or directors. They might have made some suggestions or changes; I don't think many. During the course of these suggestions, these 10,000 shares of Public Utility Investing Corporation's Preferred were added to the list before it was completed. I don't think anybody gave much thought to the individual securities, because they all knew about the various companies of the Associated System. We were satisfied with these other investments in the companies up in New England, so there was not very much research work put on the list when the portfolio was prepared for Eastern Utilities Investing Corporation.

This list of securities to be transferred to Eastern Utilities Investing Corporation was prepared either under the direction of Mr. Hopson or Mr. Daly, his assistant.<sup>146</sup> As previously stated, Mr. Hopson was the president and a director of Eastern Utilities Investing Corporation on July 31, 1927, when this exchange was made.<sup>147</sup> Mr. Hopson was also president and director of Public Utility Investing Corporation and had a substantial interest in the common stock of that corporation at the time of this transaction.<sup>148</sup> The other two directors of Public Utility Investing Corporation were R. N. Thompson<sup>149</sup> (a Hopson service company accountant<sup>150</sup>) and Miss M. C. O'Keefe (secretarial assistant to Mr. Hopson and secretary of Associated Gas and Electric Company), who had been associated with Mr. Hopson since about 1918.<sup>151</sup>

The balance sheet of Public Utility Investing Corporation as at December 31, 1927, reveals that at the end of 1927 the corporation had outstanding 76,000 shares of common stock and 15,000 shares of \$6.00 Dividend Series preferred stock. Its capitalization and surplus aggregated \$3,022,236.25 of which the preferred stock amounted to \$1,500,000 and the common stock and surplus were stated at \$1,522,236.25.<sup>152</sup>

Eastern Utilities Investing Corporation acquired \$1,000,000 of the \$6.00 Dividend Series preferred stock.<sup>153</sup> In April 1928 Public Utility Investing Corporation issued \$2,000,000 of debentures which thus were interposed ahead of its \$6 Dividend Series preferred stock acquired by Eastern Utilities Investing Corporation on July 31, 1927.<sup>154</sup>

The investment by Eastern Utilities Investing Corporation of \$1,000,000 in the preferred stock of the Public Utility Investing Corporation was, as admitted by Mr. Stix, "to the distinct advantage of the holders of common stock of Public Utility Investing Corpora-

<sup>146</sup> Id., at 23376, 24680-1, 24687-8.

<sup>147</sup> Id., at 23394.

<sup>148</sup> Id., at 23377, 23385, and *supra*, p. 651.

<sup>149</sup> Id., at 23377.

<sup>150</sup> Id., at 23367-8.

<sup>151</sup> Id., at 23377-8.

<sup>152</sup> Contained in the annual report of that company for 1929 attached to the summary statement filed with the Commission by Public Utility Investing Corporation. (Id., Commission's Exhibit No. 3777.)

<sup>153</sup> Id., at 23389 and *supra*, p. 652.

<sup>154</sup> Id., at 23389 and Commission's Exhibit No. 3778.

tion,"<sup>155</sup> and therefore to the advantage of Mr. Hopson who was substantially interested in Public Utility Investing Corporation common stock.<sup>156</sup>

In contrast to the investments of Eastern Utilities Investing Corporation, the portfolio of Public Utility Investing Corporation in which Mr. Hopson had a large investment was diversified<sup>157</sup> and was designed to exclude Associated Gas and Electric Company's securities.<sup>158</sup> As Mr. Stix testified regarding the portfolio policy of Public Utility Investing Corporation:<sup>159</sup>

Q. Have you any information as to whether practically the entire investment in terms of dollar amount was in companies in the Associated Gas & Electric System?

A. No; I would be inclined to say it would be just the reverse. I recall talking about it with Mr. Hopson and he agreed with the position that I took that it would not be wise to have the predominance of the Associated investments in Public Utility Investing Corporation.

Q. What was the reason for feeling that way?

A. Well, I felt that a diversified list of securities for a company that I understood he had an interest in, would be a lot better than for him to depend upon his connection with the Associated at that time for a livelihood, and also have most of his money invested directly or indirectly in Associated securities.

Q. So you were suggesting a way in which he could diversify his investments?

A. He and whoever else were the security holders of Public Utility Investing Corporation.

#### b. Investment in Consumers Construction Company

Also included in the list of securities transferred on July 31, 1927, to Eastern Utilities Investing Corporation in substitution for the "due bill" was the preferred stock of Consumers Construction Company. It will be recalled<sup>160</sup> that the operating companies in the "System" including the previous operating company subsidiaries of Eastern Utilities Investing Corporation (then known as the Pennsylvania Electric Corporation) had been required by Associated Gas and Electric Company to enter into service contracts with Associated Gas and Electric Company. The construction service contracts called for the payment of 7½% of additions to fixed capital for construction services rendered. On March 30, 1927, the management of Associated Gas and Electric Company formed a new company called Consumers Construction Company,<sup>161</sup> to which company some of these service contracts

<sup>155</sup> Id., at 23393-4.

<sup>156</sup> Id., at 23359-60, 23368, 23380, 23390, and supra, p. 651.

<sup>157</sup> The portfolio of Public Utility Investing Corporation at December 31, 1929, consisted of a diversified list of stocks of utility companies aggregating in cost \$6,399,908.40; bank and trust company stocks aggregating in cost \$1,440,053.00; miscellaneous assortment of stocks—railroad companies, investing companies, and industrials—aggregating in cost \$1,682,716.63; a list of bonds of public utilities, industrials, municipalities, and real estate companies aggregating in cost \$1,190,852.97; and some investment in short-term notes aggregating \$711,503. These constituted the total investment of \$11,425,034.59 by Public Utility Investing Corporation. (Id., at 23378-9 and summary statement filed with the Commission by Public Utility Investing Corporation.)

<sup>158</sup> See infra, p. 654.

<sup>159</sup> Op. cit. supra, note 6, at 23380-1.

<sup>160</sup> See supra, pp. 635-8, *Service Charges of Subsidiaries*.

<sup>161</sup> Op. cit. supra, note 6, at 23395

were assigned.<sup>162</sup> In consideration for this transfer, Associated Gas and Electric Company received 100,000 shares of common stock of Consumers Construction Company,<sup>163</sup> which were subsequently recapitalized into 10,000 shares of common with a stated or par value of \$100,000 and 50,000 shares of preferred stock with a preference on liquidation of \$5,000,000.<sup>164</sup> It was this block of preferred stock of Consumers Construction Company which was placed in the portfolio of Eastern Utilities Investing Corporation as part of the list of securities transferred in lieu of the "due bill."

With respect to the organization and capitalization of Consumers Construction Company, Mr. Stix stated that he determined the amount of preferred stock which could be issued by estimating what profit the company would make from the contracts assigned to it and then determining the number of shares whose dividends could be paid by such profit.<sup>165</sup>

A. I think I made some estimates of what the contracts would probably produce and predicated the amount of preferred stock upon the amount of earnings the company would have, and which it in turn could pay as dividends on the preferred stock.

Q. What was your estimate of the amount of the earnings?

A. I don't recall the precise figures but I know it was substantially in excess of the dividend requirements on the 50,000 shares of preferred stock.

The assets of Consumers Construction Company consisted solely of these construction contracts, capitalized at \$5,100,000,<sup>166</sup> made by Associated Gas and Electric Company with its controlled operating companies.<sup>167</sup>

As was testified to by Mr. Stix, the board of directors of Consumers Construction Company went through the formal motions of fixing a certain value for the contracts.<sup>168</sup>

<sup>162</sup> Id., at 23395, 23406-7. The service contracts assigned to Consumers Construction Company account for \$5,100,000 of the \$28,000,000 aggregate amount at which Associated Gas and Electric Company caused the service contracts with its subsidiaries to be capitalized.

<sup>163</sup> Id., at 23396-7 and 23400.

<sup>164</sup> Id., at 23395 and 23399.

<sup>165</sup> Id., at 23405.

<sup>166</sup> Id., at 23400.

<sup>167</sup> Associated Gas and Electric Company had the absolute power to select the members of the boards of directors of these companies, with which the contracts were made, with the possible exception of the Cambridge Electric Light Company, the Cambridge Gas Light Company, the Worcester Gas Light Company, and the Cape and Vineyard Electric Company. These boards of directors, in turn, had the power to hire and discharge the officers of these companies with which contracts were made. (Id., at 23403-4.)

<sup>168</sup> Id., at 23406. Mr. Stix testified with respect to the control of the operating companies by Associated Gas and Electric Company as follows (id., at 23411-2):

Q. It [Associated Gas and Electric Company] had complete control of the operating companies?

A. Yes; subject to the board of directors.

Q. Associated had the power to select the directors of the operating companies?

A. Yes.

Q. And the board of directors had the power to hire or fire the officers of the operating company, isn't that right?

A. That is correct.

Q. And it would be the officers of the operating companies who would execute the management contracts with the Associated Gas and Electric Company, isn't that right?

A. Yes; ratified by the board of directors.

Mr. Stix (who had been active in the organization and capitalization of Consumers Construction Company) testified that, although he did not have "the slightest idea" who were the directors of Consumers Construction Company, he was "sure" they were representatives of the Associated Gas and Electric Company. (Id., at 23407.)

Q. Do you call them formal motions when they are required by law to reach the consideration received for the issuance of securities?

A. I don't think it means a thing.

\* \* \* \* \*

Q. They determined they were at least worth \$5,000,000?

A. I suppose they did, to satisfy the legal requirements.

\* \* \* \* \*

Q. They accepted the amounts you fixed?

A. They didn't change them, so they must have accepted them.

The service contracts assigned by Associated Gas and Electric Company to Consumers Construction Company were valued at \$5,000,000 or more, apparently for the purpose of permitting the creation by Consumers Construction Company of \$5,000,000 of its preferred stock. Associated Gas and Electric Company sold these 50,000 shares of preferred with a preference on liquidation of \$5,000,000 to Eastern Utilities Investing Corporation for \$5,000,000.<sup>169</sup>

Associated Gas and Electric Company had obtained these service contracts as an incident of control of the operating companies. No cash or property consideration had been paid by the Associated Gas and Electric Company for these contracts.<sup>170</sup> Yet, by causing Eastern Utilities Investing Corporation to buy all the outstanding preferred stock of the Consumers Construction Company, to which these contracts had been assigned, Associated Gas and Electric Company was selling its subsidiary an indirect interest in these contracts for \$5,000,000. And furthermore, Associated Gas and Electric Company, through its ownership of the common stock of Consumers Construction Company, retained control of these contracts and the right to all profits in excess of \$7 a share on the 50,000 shares of preferred stock, i. e., in excess of \$350,000 a year.<sup>171</sup> Moreover, it is significant that the ownership of the common stock, representing both the control and the profits aspect of Consumers Construction Company, was retained by Associated Gas and Electric Company despite the fact that Eastern Utilities Investing Corporation paid Associated Gas and Electric Company over 98% of the arbitrarily assigned value of Consumers Construction Company.<sup>172</sup> Mr. Stix testified:<sup>173</sup>

Q. By retention of the common stock of Consumers Construction Company, the Associated Gas and Electric Company retained the right to receive all of the profits of Consumers Construction Company after payment of preferred dividends; isn't that right?

A. That is correct.

Q. And Associated Gas and Electric Company also received \$5,000,000 of its own preferred stock for the 50,000 shares of Consumers Construction Company's stock which it conveyed to Eastern Utilities Investing Corporation?

A. Yes; it was relieved of an obligation to deliver 50,000 shares of \$7.00 preferred stock, thus virtually reacquiring its own stock.

<sup>169</sup> Id., at 23394-5. The \$5,000,000 was paid by relieving Associated Gas and Electric Company of an obligation under the due bill to deliver to Eastern Utilities Investing Corporation 50,000 shares of \$7 preferred stock of Associated Gas and Electric Company. (Id., at 23409.)

<sup>170</sup> Mr. Stix, however, contended that in determining the price they would pay for a utility system they included reimbursement to the old controlling interests for loss of the right to service the system. (Id., at 23409-10.)

<sup>171</sup> Id., at 23413 and *supra*.

<sup>172</sup> Id., at 23409.

<sup>173</sup> Id., at 23413.

Part of the prospective profits on the basis of which Mr. Stix valued the service contracts in which Eastern Utilities Investing Corporation was making an indirect investment were to be profits from services to be rendered to the former subsidiaries of Eastern Utilities Investing Corporation.<sup>174</sup>

Mr. Stix actively participated in the organization of Consumers Construction Company, in the valuation of its assets, and in the creation of its capital structure. The directors of Consumers Construction Company and of Eastern Utilities Investing Corporation were representatives of the Associated Gas and Electric Company,<sup>175</sup> and this investment of Eastern Utilities in the preferred stock of Consumers Construction Company could not have resulted from arm's-length bargaining.

Eastern Utilities Investing Corporation, when caused on July 31, 1927, to make this investment in the preferred stock of Consumers Construction Company, was a subsidiary of Associated Gas and Electric Company whose consolidated statements would have to include Eastern Utilities Investing Corporation. However, by the time its next annual report was issued, Eastern Utilities Investing Corporation had been made a subsidiary of Eastern Utilities Investing Trust, another subsidiary of Associated Gas & Electric Properties, although Associated Gas and Electric Company still retained the power of control through an option to reacquire the control stock of Eastern Utilities Investing Corporation. The fact that it did not own the voting stock permitted Associated Gas and Electric Company to issue unconsolidated statements excluding Eastern Utilities Investing Corporation, even though Associated Gas and Electric Company controlled Eastern Utilities Investing Corporation through an option to reacquire its stock from Eastern Utilities Investing Trust at cost.<sup>176</sup>

Since Associated Gas and Electric Company did not pay any cash or property for the service contracts it obtained from its subsidiaries, the capitalization of these contracts at substantial amounts constituted a write-up of these contracts even though they had been assigned to service subsidiaries of Associated Gas and Electric Company and were capitalized on the books of those subsidiaries. The appraisal on which the write-ups were based was made by Mr. Stix in the case of Consumers Construction Company<sup>177</sup> and perhaps in the other cases. The \$5,000,000 of Consumers Construction Company preferred was based on the write-up of its service contracts.

When Associated Gas and Electric Company acquired this preferred, the stock was entirely based on the write-up. Then when Associated Gas and Electric Company caused Eastern Utilities Investing Corporation to buy this preferred and in payment therefor release Associated Gas and Electric Company from an obligation to deliver \$5,000,000 of its own preferred, Associated Gas and Electric Company had received payment on the basis of the written-up value of \$5,000,000.

<sup>174</sup> It will be recalled that Consumers Construction Company did not attempt to render services, but had retained another company to perform these services for a specified annual retainer.

<sup>175</sup> *Op. cit. supra*, note 6, at 23407.

<sup>176</sup> *Id.*, at 23346-7, Commission's Exhibit No. 3480, and Appendix H, p. 798.

<sup>177</sup> See *supra*, p. 655.

By the device of making Eastern Utilities Investing Corporation a subsidiary of Eastern Utilities Investing Trust, Associated Gas and Electric Company caused the written-up assets to be reflected in the balance sheet of a controlled company not included in its consolidated statements and at the same time through having been released from its obligation to deliver preferred stock to Eastern Utilities Investing Corporation was enabled to show \$5,000,000 less preferred stock on the liability side of Associated Gas and Electric Company's consolidated balance sheet. And when Eastern Utilities Investing Corporation publicly issued securities, the public was contributing cash to a company whose portfolio included these written-up securities.<sup>178</sup>

### c. Investment in Managing and Investing, Inc.

Included in the list of securities transferred on July 31, 1927, to Eastern Utilities Investing Corporation were 50,000 shares of preferred stock of Managing and Investing, Inc., at an aggregate cost of \$5,000,000.<sup>179</sup>

Managing and Investing, Inc., had been organized in September 1924,<sup>180</sup> and its stock had been owned by Mr. Mange and his family prior to its acquisition by the "System" in March 1927.<sup>181</sup>

In March 1927, the charter of Managing and Investing, Inc., was amended to authorize the issuance of a total of 60,000 shares no-par stock, of which 10,000 shares were common and 50,000 shares were preferred stock. A few days later, another amendment was made increasing the authorization of preferred stock to a total of 65,000 shares.<sup>182</sup> The Associated Gas and Electric Company paid \$5,200,000 in cash for all of this common stock and preferred stock of Managing and Investing, Inc.<sup>183</sup> This cash was used by Managing and Investing,

<sup>178</sup> Eastern Utilities Investing Corporation retained the preferred stock of Consumers Construction Company until the acquisition by Associated interests of W. S. Barstow and Company, when those engineering contracts held by Consumers Construction Company were transferred to W. S. Barstow and Company and thereupon the preferred stocks of W. S. Barstow and Company were substituted in the Eastern Utilities Investing Corporation portfolio for the preferred stock of the Consumers Construction Company. All preferred stocks of service companies which Eastern Utilities Investing Corporation held in December 1930 were relinquished by it to Associated Gas and Electric Company or a subsidiary of Associated Gas and Electric Company for a due bill for 108,775 shares of Associated Gas and Electric Company \$6.50 preferred stock. (Id., at 25802-14.) And although Mr. Stix testified (id., at 25806) :

Q. And the only assets behind these preferred stocks which Eastern Utilities Investing Corporation disposed of in December of 1930 were service contracts?

A. That is right, other than some relatively small amount of working capital.

Mr. Stix also testified that these preferred stocks were the best investments Eastern Utilities Investing Corporation had at the time and even better than the Associated Gas and Electric Company \$6.50 preferred stock for which they were exchanged. (Op. cit. supra, note 46, pp. 2438-41.)

<sup>179</sup> Op. cit. supra, note 6, at 23414-5.

<sup>180</sup> Id., at 23415. Upon organization of Managing and Investing, Inc., J. I. Mange became the president, treasurer, and one of its directors. Mr. Stix, who prepared the list of securities transferred to Eastern Utilities Investing Corporation on July 31, 1927, which list included Managing and Investing, Inc., testified that he was not familiar with that company until March 1927. (Id., at 23416.)

<sup>181</sup> Id., at 23415-7. Apparently the above-mentioned Managing and Investing, Inc. is a different company from Managing and Investing, Incorporated which was used by Mr. Mange to hold his half-interest in Associated Gas & Electric Properties. See Appendix G, note 17, p. 793.)

<sup>182</sup> Id., at 23415-7.

<sup>183</sup> Id., at 23418.



Inc., to buy \$5,227,000 of the income notes of the Massachusetts Electric Investment Association which later changed its name to Manson Securities Trust, and later became Utilities Investing Trust.<sup>184</sup> Massachusetts Electric Investment Association was controlled by Associated Gas & Electric Properties, which was owned and controlled by Mr. Hopson and Mr. Mange.<sup>185</sup>

The interest on the notes was payable out of income to the extent of but not to exceed 8 percent.<sup>186</sup> However, Mr. Stix testified:<sup>187</sup>

Q. As a matter of fact, it never came near 8 percent. Wasn't it always much less than 8 percent?

A. That would be my recollection now, that it never got up as high as 8 percent.

Through a series of subsequent transactions that took place between March and July 1927, Managing and Investing, Inc., received about 50,000 shares of Associated preferred stock "of some kind" in place of the income notes.<sup>188</sup> In July or August, 1927, it returned these 50,000 shares of preferred stock of Associated Gas and Electric Company to the issuer in exchange for the transfer to Managing and Investing, Inc., of certain management contracts with operating companies of the "System."<sup>189</sup> At the end of 1927, and probably as early as July 31, 1927, when Associated Gas and Electric Company caused the Eastern Utilities Investing Corporation to accept the 50,000 shares of preferred stock of Managing and Investing, Inc., at a cost of \$5,000,000, these management contracts constituted "the only real assets"<sup>190</sup> of Managing and Investing, Inc.

Consequently until July or August 1927 Managing and Investing, Inc. had been an investment company.<sup>191</sup> However, about the time that Eastern Utilities Investing Corporation was caused to acquire \$5,000,000 of the preferred stock of Managing and Investing, Inc. the nature of the business of the latter corporation was changed, so that Managing and Investing, Inc., became a managing company with contracts to service public utility operating companies in the Associated Gas & Electric System.<sup>192</sup> These contracts, like those which Associated Gas and Electric Company had assigned to Consumers Construction Company, were obtained by Associated Gas and Electric Company from its subsidiaries at no cost. Yet Eastern Utilities Investing Corporation yielded its right under the due bill to receive \$5,000,000 of Associated Gas and Electric Company \$7 preferred stock in exchange for these 50,000 shares of preferred of Managing and Investing, Inc.

<sup>184</sup> Id., at 23418-9. The assets of the company which issued these notes consisted of 100% of the common and some of the preferred stocks of New England Gas and Electric Association, which owned operating companies in Massachusetts and New Hampshire, having acquired these operating properties in 1926 and 1927. (Id., at 23420 and 23428.)

<sup>185</sup> Id., at 23419.

<sup>186</sup> Id., at 23419-20.

<sup>187</sup> Id., at 23425.

<sup>188</sup> Id., at 23421. Mr. Stix could not recall the exact number of shares, the class of preferred stock, or the names of the "System" companies with which these transactions were effected.

<sup>189</sup> Id., at 23420 and 23422-3.

<sup>190</sup> Id., at 23421 and 23423 (testimony of Mr. Stix).

<sup>191</sup> Id., at 23420.

<sup>192</sup> Ibid.



which had an assigned valuation of \$5,000,000 based solely on the management contracts.

Although the process was more complex, it appears that the written-up valuation of the managing contracts conveyed to Managing and Investing, Inc., by Associated Gas and Electric Company was reflected on the asset side of Eastern Utilities Investing Corporation's published balance sheet as was the written-up value of the construction contracts held by Consumers Construction Company. And similarly, Associated Gas and Electric Company was relieved of an obligation to deliver preferred stock of its own.<sup>193</sup>

Again following the pattern of the transaction in Consumers Construction Company, Associated Gas and Electric Company retained the common stock, representing the control and the profits aspect of Managing and Investing, Inc., when it sold 50,000 shares of the preferred to Eastern Utilities Investing Corporation for \$5,000,000. Mr. Stix testified:<sup>194</sup>

Q. And Associated Gas and Electric Company retained all of the value of these construction contracts over and above the interest represented by the 50,000 shares of Managing and Investing Preferred?

A. Yes, subject to this little split of ownership which there was during some part of that period between Associated Gas and Electric Company and New England Gas and Electric Association.<sup>195</sup>

Managing and Investing, Inc., continued to hold management contracts until the spring of 1928 when the company "was relegated to the graveyard."<sup>196</sup> Eastern Utilities Investing Corporation first received preferred stock of a successor service company and then, in December 1930, Associated Gas and Electric Company preferred stock in place of the preferred stock of that service company.<sup>197</sup> Eastern Utilities Investing Corporation relinquished all its preferred stocks of service companies at that time to facilitate the "System's" plan to rearrange these service companies,<sup>198</sup> although these preferred stocks, according to Mr. Stix, were the best investments in Eastern Utilities Investing Corporation's portfolio at the time.<sup>199</sup>

<sup>193</sup> See *supra*, p. 656.

<sup>194</sup> *Op. cit. supra*, note 6, at 23423-4.

<sup>195</sup> New England Gas and Electric Association was also a subsidiary of Associated Gas & Electric Properties, as was Associated Gas and Electric Company, and so was likewise within the Associated Gas & Electric System.

<sup>196</sup> *Op. cit. supra*, note 6, at 23420-1.

<sup>197</sup> Eastern Utilities Investing Corporation retained the preferred stock of Managing and Investing, Inc., until the acquisition of control of J. G. White Management Corporation when those management contracts held by Managing and Investing, Inc., were transferred to J. G. White Management Corporation whose stock in turn was owned by Management Holding Corporation. At that point the preferred stock of Management Holding Corporation was substituted in the Eastern Utilities Investing Corporation portfolio for the preferred stock of Managing and Investing, Inc. In December 1930, all service company preferred stocks which Eastern Utilities Investing Company held were relinquished by it in return for a due bill for 108,775 shares of Associated Gas and Electric Company \$6.50 preferred stock. (*Id.*, at 25802-14.)

<sup>198</sup> *Op. cit. supra*, note 6, at 25811-2.

<sup>199</sup> *Op. cit. supra*, note 46, pp. 2438-41. Mr. Stix admitted that these service company preferred stocks were better than the consideration Eastern Utilities Investing Corporation received in return for them, i. e., the \$6.50 preferred stock of Associated Gas and Electric Company. (*Ibid.* See also *op. cit. supra*, note 6, Commission's Exhibit No. 3771, Pt. VII, Tables 32 and 33.)

#### d. Investment in Gas and Electric Associates

As part of the exchange of July 31, 1927, Eastern Utilities Investing Corporation also invested \$7,500,000 in Gas and Electric Associates,<sup>200</sup> a subsidiary of Associated Gas & Electric Properties. This investment paralleled the investment in Managing and Investing, Inc. insofar as income notes are concerned, for Gas and Electric Associates owned, as its sole investment, \$14,012,143.97 face amount of Massachusetts Electric Investment Association 8% income notes<sup>201</sup>—of the same issue or series as those notes which Managing and Investing, Inc., had exchanged for service contracts with the System subsidiaries. As stated above, Massachusetts Electric Investment Association, as well as Gas and Electric Associates, was controlled by Associated Gas & Electric Properties, which was owned and controlled by Mr. Hopson and Mr. Mange. This investment by Eastern Utilities Investing Corporation in Gas and Electric Associates was therefore practically the equivalent of a loan by Eastern Utilities Investing Corporation to Mr. Hopson and Mr. Mange.

#### e. Investment in Associated Electric Company

Also as part of the exchange of July 31, 1927, Eastern Utilities Investing Corporation invested about \$2,000,000 in 5½% bonds of Associated Electric Company, the company to which Eastern Utilities Investing Corporation (then known as Pennsylvania Electric Corporation) had been caused to transfer its operating subsidiaries in the spring of 1926.<sup>202</sup>

#### f. Investment in Associated Gas and Electric Company Securities

As part of the exchange of July 31, 1927, Eastern Utilities Investing Corporation invested about \$9,400,000 in securities issued by Associated Gas and Electric Company.

With the passage of time more and more of the resources of Eastern Utilities Investing Corporation were put into securities issued by Associated Gas and Electric Company. By the end of 1931, the portfolio of the Eastern Utilities Investing Corporation consisted only of Associated Gas and Electric Company securities, a block of General Gas & Electric Corporation Class A stock and \$200,000 of 6% promissory notes of the Cities Service Company.<sup>203</sup>

<sup>200</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3772, Item 2.

<sup>201</sup> Id., at 23428, and Commission's Exhibit No. 3772, Item 34. Notes of Massachusetts Electric Investment Association continued until 1935 to be the sole investment of Gas and Electric Associates, although the amount varied and the name of the issuer was changed to Manson Securities Trust and then to Utilities Investment Trust. (Ibid.)

<sup>202</sup> Id., Commission's Exhibit No. 3772, Item 2 and supra, pp. 641-5, *Transfer of Operating Properties and Effect Thereof*. Associated Electric Company is still in existence, controls the properties which it had acquired from Eastern Utilities Investing Corporation, and is said to be in good financial condition, earning dividends. However, Eastern Utilities Investing Corporation is in receivership. As stated by its comptroller, "Yes, Eastern Utilities Investing Corporation is all washed up." (Id., at 23429.)

<sup>203</sup> Id., Commission's Exhibit No. 3771, Part II (Exhibit A, Schedule 9) and Part III, Table 2.

## 10. NATURE OF EXCHANGE TRANSACTION OF JULY 31, 1927

In connection with this exchange of July 31, 1927, the controlling interests not only determined the prices to be paid by Eastern Utilities Investing Corporation for the securities acquired from the Associated Gas and Electric Company, but actually sponsored and organized at least four of the companies issuing those securities: Consumers Construction Company, Managing and Investing, Inc., Gas and Electric Associates, and Associated Electric Company.

To recapitulate, the investment of Eastern Utilities Investing Corporation in Consumers Construction Company was in effect an investment, at a written-up valuation, in service contracts with operating company subsidiaries including the operating companies which Eastern Utilities Investing Corporation (then Pennsylvania Electric Corporation) had owned. The investment in Gas and Electric Associates was tantamount to a loan to Messrs. Hopson and Mange. The investment in Managing and Investing, Inc. appears to have the aspects of the investments in the Consumers Construction Company and the Gas and Electric Associates. The Investment in Public Utility Investing Corporation was in an investing company of which H. C. Hopson was a large stockholder at the time of this exchange. The other large investments made by Eastern Utilities Investing Corporation at this time were directly in its parent, Associated Gas and Electric Company, and in the subholding company which its parent had organized to take over Eastern Utilities Investing Corporation's (formerly Pennsylvania Electric Corporation) utility system.

The following table gives an approximate summary of these investments of July 31, 1927, and their percentage of the total portfolio of Eastern Utilities Investing Corporation:

	Amount	Percent
Public Utility Investing Corporation.....	\$1,000,000	3.1
Consumers Construction Co.....	5,000,000	15.2
Managing and Investing, Inc.....	5,000,000	15.2
Gas and Electric Associates.....	7,500,000	22.9
Associated Electric Co.....	2,000,000	6.1
Associated Gas & Electric Co.....	9,400,000	28.7
Total affiliated companies.....	29,900,000	91.2
Other investments.....	2,900,000	8.8
Total portfolio.....	32,800,000	100.0

Eastern Utilities Investing Corporation retained these investments with very few changes from July 1927 until March 1929, when Eastern Utilities Investing Corporation sold \$35,000,000 principal amount of its debentures to the public.<sup>204</sup>

<sup>204</sup> However, the total portfolio was increased by the investment of about \$10,000,000 in securities of Utilities Power & Light Corporation, and as a result the portfolio's concentration in "System" securities decreased to about 65% by March 1929. The investment of the debenture proceeds again increased the concentration in "System" securities to about 80%. (See id., Commission's Exhibits Nos. 3772, Item 2, and No. 3805 for a list of the company's portfolio investments in July 1927 and March 1929; also see *infra*, p. 668.)

## E. Eastern Utilities Investing Corporation is Transformed Into an Investment Company

### 1. GENERAL PLAN

In the early part of 1927, not long before July 31, 1927, when the list of securities was delivered to Eastern Utilities Investing Corporation in exchange for the due bill calling for the preferred stock of Associated Gas and Electric Company, the "System" management apparently abandoned its plan of liquidating Eastern Utility Preferred Holding Corporation (the then name of Eastern Utilities Investing Corporation) and evidently decided to transform the corporation into an investment company. The nature of the portfolio transferred to it for this purpose has been described. The equity in the company was to be increased and new issues of securities were to be sold to the public as securities of an investment company.<sup>205</sup> Accordingly, on July 26, 1927, the name of the company was changed to Eastern Utilities Investing Corporation,<sup>206</sup> indicating its purported new function.

### 2. RECAPITALIZATION

The balance sheet of Eastern Utility Preferred Holding Corporation, as at December 31, 1926, indicated that 70,766 shares of its 7% preferred stock and a small amount of its scrip were outstanding.<sup>207</sup> About 49,000 of those preferred shares were held by the "System" and approximately 21,000 preferred shares were held by the public.<sup>208</sup> This 7% preferred stock was at that time senior to all other securities issued by Eastern Utility Preferred Holding Corporation. There were also outstanding 170,685 shares of common stock of Eastern Utility Preferred Holding Corporation which were mostly held by the "System."<sup>209</sup> By July 1, 1927, the preferred stock outstanding had been increased to 75,000 shares and the common stock to 175,000 shares,<sup>210</sup> a majority of each class being held within the "System."

On July 31, 1927 (the date on which the list of securities was exchanged for the due bill), the controlling interest effected a complete revision of the capital structure of the Eastern Utilities Investing Corporation. The common stock with voting power was reclassified on a share for share basis into \$7 junior preferred stock, without voting rights, and the 7% preferred stock was reclassified into \$7 preferred stock, also on a share for share basis.<sup>211</sup>

<sup>205</sup> Op. cit. supra, note 6, at 23321-2. Mr. Stix, Comptroller of Eastern Utilities Investing Corporation and director for Associated Gas and Electric Company, testified:

Q. In 1927 the Associated management decided not to liquidate Eastern Utility Preferred Holding Corporation, but to use it as an investment trust, isn't that right?

A. That is correct.

Q. Were steps taken to build up the equity in Eastern Utilities Investing Corporation?

A. Yes.

Q. And then it was planned to issue securities of Eastern Utilities Investing Corporation to the public, is that right?

A. Yes, sir.

<sup>206</sup> See note 9, supra.

<sup>207</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3772, Item 56.

<sup>208</sup> Id., at 25699.

<sup>209</sup> Ibid.

<sup>210</sup> Id., Commission's Exhibit No. 3772, Item 60.

<sup>211</sup> Id., at 23333-41 and 25699-700.

Moreover, the capital structure was made more complex by the creation of three additional classes of securities: \$5.50 prior preference stock, Class A common stock, and Class B common stock.<sup>212</sup>

The \$5.50 prior preference stock was entitled to a preference on involuntary liquidation of \$100 per share,<sup>213</sup> and was made senior to all other issues, thus placing the old 7% preferred stock, in which the public was chiefly interested, in a junior position.<sup>214</sup> All of the \$5.50 prior preference stock, 75,000 shares, was issued to Associated Gas and Electric Securities Company, Inc., a "System" company, in exchange for securities of an assigned value of \$7,275,000, or \$97 per share. The Class A common stock and the Class B common stock (the sole voting stock) consisted of 100,000 shares each, all of which were acquired by the "System" for a total consideration of \$100,000.<sup>215</sup> The "System," therefore, transferred to Eastern Utilities Investing Corporation an aggregate of \$7,375,000, \$7,275,000 in securities for which it received all of the \$5.50 prior preference stock, or a prior claim of \$7,500,000 on liquidation (besides a prior claim on dividends) and \$100,000 in either cash or securities for which the "System" received all of the voting securities of Eastern Utilities Investing Corporation<sup>216</sup> as well as all the Class A stock. By this reclassification, the minority common stockholders lost their voting rights and the minority preferred stockholders lost their priority. The size of the minority interest submerged by this recapitalization is indicated by the following table showing the participation of the public in the securities of Eastern Utilities Investing Corporation and the percentage of the outstanding shares as at December 31, 1927.<sup>217</sup>

Class	Held by public	
	Shares	Percent of outstanding
\$5.50 prior preference stock.....	128	0.2
\$7 preferred stock.....	15,337	20.4
\$7 junior preferred stock <sup>218</sup> .....	1,256	0.7
Class A.....	0	0
Class B.....	0	0

<sup>218</sup> Non-cumulative. Represented by common stock certificates of Pennsylvania Electric Corporation. In 1928, redesignated as "Participating Preference Stock." Id., Commission's Exhibit No. 3771, Part I.

<sup>212</sup> Ibid.

<sup>213</sup> Id., Commission's Exhibit No. 3771, Part V, Item 35-D.

<sup>214</sup> Id., at 25700.

<sup>215</sup> Id., at 23341-4 and 25701. Although Mr. Stix thought he recalled a check for \$100,000 passing to Eastern Utilities Investing Corporation in payment for its Class A and Class B stock, the minutes of its Board of Directors meeting on July 26, 1927, recorded the consideration as \$100,000 par value of Associated Electric Company 5½% Convertible Gold Bonds. (Id., at 23344 and supplementary information concerning Eastern Utilities Investing Corporation, Minutes of Board of Directors.) In any event, the purchaser resold the 100,000 shares of Class B voting stock for \$100,000 on open account to Eastern Utilities Investing Trust, also within the System, with the result, as Mr. Stix described it, "that if it ever collected \$100,000 from Eastern Utilities Investing Trust that the 100,000 shares of Class A stock which they got would not have cost them anything." (Id., at 23343.)

<sup>216</sup> Mr. Stix testified (id., at 25700):

Q. Then one of the results of this recapitalization of July 31, 1927, was that the Associated System received securities senior to the minority holders of the old 7% preferred stock?

A. That is part of the result; yes.

<sup>217</sup> Id., Commission's Exhibit No. 3772, Item 6.

This rearrangement of priorities and creation of additional securities was partly motivated by the desire of the controlling interests to sell the \$5.50 prior-preference stock and the Class A common (non-voting) to the public. Although a "System" company in the first instance purchased the 75,000 shares (all of the shares issued) of the prior-preference stock and the 100,000 shares of Class A common stock, these purchases were not intended for investment purposes but for ultimate resale to the public.<sup>219</sup> It was patently never intended to sell any of the Class B common stock (the voting stock) and this stock, although transferred repeatedly, was held at all times by some "System" company.<sup>220</sup> The "System" attempted to sell as much as it could of the \$5.50 prior-preference stock and the Class A common stock to the public, but only a few shares were actually sold to the public until 1929. However, by the end of 1929, the public held 5,324 shares of \$5 prior preferred, "which took the place of the \$5.50 [prior] preference," and 197,818 shares of Class A.<sup>221</sup>

The Class A common stock had been set up on the books of the Eastern Utilities Investing Corporation at 50 cents per share, for Associated Gas and Electric Company had paid \$100,000 for both the block of 100,000 shares of Class A and the block of 100,000 shares of Class B voting stock,<sup>222</sup> but in March 1929 Class A stock was offered the public at \$15 per share.<sup>223</sup>

Apparently in order to induce the former minority common-stock holders of Pennsylvania Electric Corporation (subsequently Eastern Utilities Investing Corporation) whose stock had been without their consent reclassified into junior preferred stock to approve the reclassification by exchanging their old common stock for the new junior preferred stock, the controlling interests did not pay dividends to the holders of the common-stock certificates, but only to the holders

<sup>219</sup> Id., at 25703-4 and Commission's Exhibit No. 3772, Item 6. The Minutes of the Eastern Utilities Investing Corporation board meeting of July 26, 1927 reveal that this transaction was to take the form of an underwriting by Associated Gas and Electric Securities Company, Inc., and that the underwriting commission to that company would be \$2 per share. (Derived from supplementary information supplied the Commission for Eastern Utilities Investing Corporation.)

<sup>220</sup> These constant switches of the control stock from one company to another were undoubtedly motivated and prompted by the exigencies of reporting the financial condition of various companies. (See id., at 23344-5. These changes are shown in op. cit. supra, note 6, Commission's Exhibit No. 3771, Part VIII, Item 77.)

Associated Gas and Electric Company held a preferential option on this control stock, thus assuring to itself the power to control Eastern Utilities Investing Corporation at will, but avoiding a consolidation of its accounts with those of Associated Gas and Electric Company. In 1932, Associated Gas and Electric Company exercised that option. (Id., at 23344-7 and Commission's Exhibit No. 3772, Item 5.)

Mr. Stix, testifying with regard to the exercise of this option at that time, stated (id., at 23344): "By that time we were in the era of more disclosures to security holders, simplification of corporate structures and consolidation of subsidiaries and affiliated companies and it was decided in order to avoid this so-called complication that it would be best to have Associated [Gas and Electric Company] reacquire the Class B. stock."

<sup>221</sup> Id., at 25703-4 and Commission's Exhibit No. 3772, Item 6.

<sup>222</sup> Id., Commission's Exhibit No. 3771, Part III, Exhibit A (Schedules 18B and C).

<sup>223</sup> In March 1929, the Company sold \$35,000,000 of debentures. Each \$1,000 principal amount of debentures carried nondetachable warrants for the purchase of 20 shares of Class A common stock at \$15 per share. The market was then about \$16½ bid—\$17 asked, but rose to \$37—\$37½ by June 1929 and sank to \$0.25 bid—\$0.75 asked by June 1932. (Id., Commission's Exhibits Nos. 3771 (Part I, Offering circular) and 3824.) Pyncheon and Company, a brokerage house, was the principal dealer in the Class A stock, both before and after the debenture issue.

of junior preferred-stock certificates into which the common stock had been reclassified. Mr. Stix, when questioned whether this device was employed in order to induce the exchange, testified: <sup>224</sup>

A. The holders of the certificates that were originally marked "common stock" were told to send their certificates in for exchange into junior preferred, and upon making exchange of the certificates they would receive the dividend declared on the stock they were to receive.

Q. But they could not receive the dividends unless they exchanged their certificates?

A. I think that was the effect of the action.

Q. That was intended as an inducement to the holders of these securities?

A. It was to overcome the inertia most security holders have.

\* \* \* \* \*

Q. If the minority holder did not want to exchange, he could not receive any dividends until he did exchange, could he?

A. That is correct.

There were several other devices employed by the controlling interest in connection with the July 31, 1927, recapitalization of Eastern Utilities Investing Corporation which were adverse to the interests of the public investment in the company.

The \$5.50 prior preference stock of Eastern Utilities Investing Corporation was purchased by the "System" at \$97 per share. However, the controlling interests, acting through the board of directors, allocated only \$1 of the proceeds of \$97 per share to stated capital,<sup>225</sup> and the balance of \$96 per share was allocated to capital surplus.<sup>226</sup> Since the company was permitted to pay dividends out of capital surplus, the action of the Board made it possible to pay preferred or common dividends out of practically all of the capital raised from this issue. Although dividends were not in fact paid out of the capital surplus account,<sup>227</sup> yet this account as augmented by various later reductions in stated capital, was eventually used to absorb depreciation on securities and thus made possible the payment of dividends out of the so-called "corporate surplus account."<sup>228</sup> This latter account<sup>229</sup> would have been insufficient for the payment of dividends

<sup>224</sup> Id., Commission's Exhibit No. 3771, Part II, Exhibit A (Schedules 18B and C).

<sup>225</sup> Id., at 23334-5 and 23338. See also Commission's Exhibit No. 3771, Part II, Exhibit A (Schedules 19G and 19H).

<sup>226</sup> The same allocation of practically all of the proceeds to capital surplus was made in respect to the 75,000 shares of \$5 prior preferred stock in May 1928 "which (as Mr. Stix said) took the place of the \$5.50 preference." (Id., at 25703-4.) At December 31, 1929, 5,324 shares of this \$5 prior preferred were held by the public. (Id., Commission's Exhibit No. 3772, Item 6.) The \$5.50 issue of July 1927 was retired in 1928.

<sup>227</sup> Id., Commission's Exhibit No. 3771, Part II, Exhibit A (Schedule 20).

<sup>228</sup> Ibid.

<sup>229</sup> This account was comprised chiefly of interest and dividend income (after deduction for interest and taxes) and of profits realized from the sale of securities in the period to 1930. According to the company's books, the net income in this account and dividends paid from 1927 to 1935 were as follows:

	<i>Net income</i>	<i>Cash dividends</i>
1927-----	2, 167, 543	613, 306
1928-----	2, 605, 305	2, 723, 438
1929-----	3, 728, 836	2, 013, 395
1930-----	2, 394, 298	2, 052, 860
1931-----	2, 084, 321	2, 052, 723
1932-----	682, 237	562 859
1933-----	(502, 941)	-----
1934-----	(414, 063)	-----
1935-----	(158, 413)	-----

(Id., Commission's Exhibit No. 3771, Part II, Exhibit A (Schedule 20) and Part V, Item 39-a.)



if it, instead of the capital surplus account, had been utilized to absorb depreciation of securities.<sup>230</sup>

The creation of this surplus illustrates the manner in which the prohibition against the payment of dividends out of capital could be avoided by the simple expedient of allocating most of the proceeds of the sale of security issues to capital surplus without knowledge or consent of the stockholders. In this way, the capital invested by the public could be paid out in dividends to insiders, or any dividends paid to the public might indicate income earned rather than partial liquidation of assets.

Despite the great importance attaching to the matter of allocation of proceeds of the sale of the prior preference stock as between capital and surplus, the question was decided by the board of directors without submission to stockholders or without even apprising the stockholders as to the allocation which would be made.

Furthermore, the allocation to capital surplus of \$96 out of every \$97 of the proceeds of the sale of the prior preference stock was concealed by an unusual accounting device employed in the annual report to stockholders. Instead of the segregation customary at the time between capital and surplus, the annual reports published by Eastern Utilities Investing Corporation lumped capital and surplus so that it was impossible to ascertain therefrom the amount of surplus and the amount of capital.

Neither did the annual reports disclose the stated or liquidating value of any of the company's outstanding securities. As a result, a holder of junior stock could not ascertain from the annual report the amount of the claims which were senior to his stock. For instance, the balance sheet as of December 31, 1927, lumped in one item the stated capital of the stock and the surplus of Eastern Utilities Investing Corporation, showing only "stated capital for stock and surplus" in the amount of \$35,213,198.73. This figure of \$35,213,198.73 appears without allocation to any particular class of stock.<sup>231</sup>

To illustrate the advantage to controlling interests of having a prior position through ownership of a preference stock it is illuminating to note the division, between the controlling interests and the public, of dividends on the participating preference stock (the name given the junior preferred stock in 1928) for the years 1928 through 1932. Such dividends amounted to over \$5,200,000 in cash.<sup>232</sup> These payments were made at the full rate of \$7 per share per year up to 1932, and aggregated about \$32 per share for the entire period. During this period the public never held more than 6% of this class of stock.<sup>233</sup> In addition to these dividends, the "System" nevertheless still held a claim for the full value on liquidation of \$7,500,000, or \$100 per share. However, during these same years the amount of dividends on the Class A stock, of which the public held 22%, aggregated, on all shares outstanding, only about \$415,000.<sup>234</sup> Moreover, when the first dividend of the Class A stock was paid, the public held only 80 shares, but when the public held

<sup>230</sup> *Id.*, Commission's Exhibit 3771. The capital surplus account provided reserves in 1930, 1931, and 1932 aggregating \$38,473,000, which absorbed that much depreciation of securities which occurred in that period. (*Ibid.*)

<sup>231</sup> *Id.*, at 2339 and Commission's Exhibit No. 3771, Part I.

<sup>232</sup> *Id.*, Commission's Exhibit No. 3771, Part V, Item 39.

<sup>233</sup> *Id.*, Commission's Exhibit No. 3772, Item 6.

<sup>234</sup> *Id.*, at 25705-7 and Commission's Exhibit No. 3771, Part V, Item 39.



its major position in the Class A stock, no dividends at all were paid.<sup>235</sup> Mr. Stix testified:<sup>236</sup>

Q. Did the public get any dividends on its investment in the Eastern Utilities Investing Corporation Class A?

A. It did not.

Q. But the "System" got dividends on the Eastern Utilities Investing Corporation participating preference?

A. Yes; it did.

Q. Would you not say, then, that where one person or one system owns the controlling stock and has a preferred position in a company, that the public in between are at its mercy?

A. Sure, if the management are thieves, but if they are honest there is nothing to it.

The recapitalization of July 31, 1927, of Eastern Utilities Investing Corporation enabled the controlling interest to exercise a prior right on liquidation up to \$7,500,000 for its prior preference stock for which, together with all of the Class A common stock and all the Class B common voting stock, the System paid only \$7,375,000 in securities.<sup>237</sup>

The Class B common stock of Eastern Utilities Investing Corporation has since July 31, 1927, been the only voting stock of that company. The charter provisions concurrently creating the Class A common stock provided that that class of stock is entitled to non-cumulative dividends in any quarterly period at the annual rate of \$1 per share before dividends are paid in the same quarter on the Class B common stock; that, after payment of a like amount per share on the Class B common stock in any quarterly dividend period, the Class A participates equally with the Class B common stock, share for share, in any additional dividends; that the Class A common stock is noncallable and shares equally, share for share, with the Class B common stock on dissolution, liquidation, or winding up; and that the Class A common stock is without par value and is nonvoting.<sup>238</sup>

### **F. Issue of \$35,000,000 Principal Amount of 5% Debentures Dated March 15, 1929, and Due March 15, 1954**

In March 1929 Eastern Utilities Investing Corporation offered to the public through Harris, Forbes & Company and Halsey, Stuart & Co., Inc., \$35,000,000 of its 5% gold debentures at a price of \$98. They were dated March 15, 1929, and due March 15, 1954. Attached to each \$1,000 principal amount of debentures was a nondetachable warrant to buy, subsequent to January 1, 1930, and prior to January 1, 1935, 20 shares of the issuer's Class A common stock at \$15 per share.<sup>239</sup>

#### **1. GENESIS OF THE ISSUE**

Eastern Utility Preferred Holding Corporation had changed its name in July 1927 to Eastern Utilities Investing Corporation for

<sup>235</sup> Ibid.

<sup>236</sup> Id., at 25710.

<sup>237</sup> Id., Commission's Exhibit No. 3771, Part V and supra, pp. 663-4.

<sup>238</sup> Id., Commission's Exhibit No. 3771, Part I.

<sup>239</sup> Id., at 23464 and Commission's Exhibit No. 3771, Part I.

the reason that the sponsors contemplated transforming the corporation into an investment company.<sup>240</sup> Beginning in July 1927 the corporation had issued stocks for sale to the public.

In the early part of 1929 H. C. Hopson felt it vitally important that his Associated Gas and Electric Company acquire the General Gas & Electric Corporation System<sup>241</sup> and no doubt conferred with Mr. Burroughs, a partner in Harris, Forbes & Company, as to methods of raising cash.<sup>242</sup> Mr. Burroughs was probably the individual who conceived the idea of having Eastern Utilities Investing Corporation put out a debenture issue,<sup>243</sup> and, in his own words, he "handled the negotiations and directed the setting up of the deal."<sup>244</sup> Mr. Burroughs and his underwriting firm had undertaken to render similar financial services to the Associated Gas & Electric System in 1926, when Harris, Forbes & Company had underwritten the \$65,000,000 debenture issue of Associated Electric Corporation and had been retained as financial sponsor for the Associated System in its expansion program.<sup>245</sup> Mr. Burroughs had formulated the plan of organizing Associated Electric Company,<sup>246</sup> for the financing of which Harris, Forbes & Company had received a large commission,<sup>247</sup> besides the bonus or retainer of 50,000 shares of Associated Gas and Electric Company common stock.<sup>248</sup> Mr. Burroughs had continued to handle the Associated account for Harris, Forbes & Company.<sup>249</sup> Mr. Burroughs and one of his partners were on the board of directors of Associated Gas and Electric Company and of Associated Electric Company.<sup>250</sup> Mr. Burroughs, therefore, probably could not approach the proposed Eastern Utilities Investing Corporation solely as a disinterested investment banker. The idea of creating the debenture

<sup>240</sup> *Id.*, at 23457. Mr. Burroughs testified (*ibid.*):

Q. When Eastern Utilities Investing Corporation's name was changed from Eastern Utility Preferred Holding Corporation to Eastern Utilities Investing Corporation, wasn't it contemplated at that time it would be made into an investment company?

A. Oh, definitely, that is the reason the name was changed.

<sup>241</sup> *Op. cit. supra*, note 46, pp. 1096-7.

<sup>242</sup> Mr. Burroughs stated with respect to the general features of the debenture issue that in the early stages of the negotiations he "took things up with Mr. Hopson and discussed them all through with Mr. Hopson and Mr. Daly." (*Op. cit. supra*, note 6, at 23486.)

<sup>243</sup> *Id.*, at 23459.

<sup>244</sup> *Id.*, at 23484.

<sup>245</sup> *Id.*, at 23440, 23445-6 and *supra*, p. 645.

<sup>246</sup> *Id.*, at 23293.

<sup>247</sup> This new corporate creature of the Associated System, Associated Electric Corporation, was caused to issue \$65,000,000 of debentures. Harris, Forbes & Company received a spread which the Federal Trade Commission Report states to have been \$10 per \$100 principal amount (*id.*, at 23442 and *op. cit. supra*, note 103, Part 46, p. 791), but which Mr. Burroughs remembered as only \$4.50 or \$5 per \$100. (*Op. cit. supra*, note 6, at 23440-1.) Also see Mr. Burroughs' testimony (*id.*, at 23441):

Q. Did it [Harris, Forbes & Company] receive any special remuneration for managing the group?

A. Yes; we had a step-up. I have forgotten how much it was. In other words, the other banks in the group did not come in on the same level Harris, Forbes did. We had a step-up.

<sup>248</sup> *Id.*, at 23445-6.

<sup>249</sup> *Id.*, at 27186-7, 27200. Mr. Burroughs testified (*id.*, at 23484):

Q. What was your primary function after you became a senior partner?

A. I negotiated the purchase of securities that the firm was going to distribute.

He also testified (*id.*, at 23435):

Q. Mr. Burroughs, what did you personally do in connection with the Eastern Utilities Investing Corporation debenture issue of 1929 and the planning of it and the consummation of it?

A. Well, I handled the negotiations and directed the setting up of the deal; it was handled under my supervision as far as the banking syndicate was concerned.

<sup>250</sup> *Id.*, at 23445.

issue originated soon after the beginning of the year 1929.<sup>251</sup> As will be indicated in more detail hereafter, the System was to raise cash for its own purposes by having Eastern Utilities Investing Corporation, an investment company, take advantage of the then prevailing popular appeal of investment trusts and sell a large debenture issue to the public. Associated Gas & Electric System, through Eastern Utilities Investing Corporation, was tapping an additional source of public funds available for investment, which was created by stimulated public fervor for investment company securities.

F. S. Burroughs testified:<sup>252</sup>

Q. Did you become impressed by the development of the investment trust [idea] in this country and decide that it might be a good idea to take that into consideration in connection with the issuance of securities by Eastern Utilities Investing Corporation?

A. You mean did I personally?

Q. Yes.

A. Yes; I was very much impressed and still am impressed with the investment trust idea.

Mr. Burroughs admitted that Harris, Forbes & Company was looking for investment banking business and that an issue of debentures by Eastern Utilities Investing Corporation would furnish such business.<sup>253</sup> He stated that a company with about \$40,000,000 of portfolio securities would be a good vehicle for issuing \$35,000,000 of debentures and that the resulting portfolio of about \$75,000,000 would be a very liberal protection for this \$35,000,000 of debentures.<sup>254</sup> This debenture issue served to facilitate the building up of the Associated Gas & Electric System, the function undertaken in 1926 by Mr. Burroughs through Harris, Forbes & Company.<sup>255</sup> Eastern Utilities Investing Corporation apparently did not issue these debentures because it felt any business need for additional funds or pursuant to any formulated plan of investments in diversified securities. Mr. Burroughs stated that when the directors of Eastern Utilities Investing Corporation decided to put out this debenture issue they did not have any idea as to the securities in which they would invest the proceeds. Mr. Burroughs testified:<sup>256</sup>

Q. You mean the directors of Eastern Utilities Investing Corporation didn't have any idea when they decided to issue these debentures as to what securities they would invest the proceeds in?

A. That is right.

He added:<sup>257</sup>

In other words, we departed from the program of raising cash for a particular purpose and adopted a program of raising cash for the sake of raising cash.

<sup>251</sup> Mr. Burroughs testified (*id.*, at 23458): “\* \* \* you said the debentures were brought out in April 1929. Then I would say we got the idea two or three months before that.”

<sup>252</sup> *Id.*, at 23455.

<sup>253</sup> Mr. Burroughs testified (*id.*, at 23459): “\* \* \* And we suggested that that company would be a good vehicle to market the debenture issue and use the proceeds to still further enlarge its portfolio. We were looking for business about that time.”

<sup>254</sup> *Id.*, at 23543-4.

<sup>255</sup> *Id.*, at 23445-6, 23448.

<sup>256</sup> *Id.*, at 23545.

<sup>257</sup> *Op. cit. supra*, note 46, pp. 1471-2.

However, as will be indicated in more detail hereafter, the subsequent use of the proceeds of the sale of these debentures clearly indicated the reason for their being publicly offered, i. e.—to raise cash to be used, not by Eastern Utilities Investing Corporation, but by the System which needed funds to consummate certain plans the System had undertaken. The fact is that the net proceeds of sale of the Eastern Utilities Investing Corporation debentures to the public, about \$32,800,000 after payment of approximately \$1,575,000 gross commissions to the bankers, was turned over to Associated Gas and Electric Company. The check to Eastern Utilities Investing Corporation from the bankers representing the proceeds of the debentures issue was immediately endorsed over to Associated Gas and Electric Company on the day of its receipt, without even being deposited in the bank account of the Eastern Utilities Investing Corporation. In lieu of this cash Eastern Utilities Investing Corporation received from Associated Gas and Electric Company, as will be indicated in more detail hereafter, a list of securities with an assigned value approximately equivalent to the cash proceeds.<sup>258</sup>

## 2. PARTICIPATION IN UNDERWRITING

Harris, Forbes & Company, which had originally recommended the \$35,000,000 debenture issue, took a 60% participation in the debenture underwriting.<sup>259</sup> Halsey, Stuart & Co., Inc., which had not theretofore been banker for the Associated Gas & Electric System, was allowed a 40% participation in this underwriting, evidently at the instance of Mr. Hopson.<sup>260</sup>

The 40% participation by Halsey, Stuart & Co., Inc., in the Eastern Utilities Investing Corporation financing was arranged by Mr. Hopson just before Halsey, Stuart & Co., Inc. rendered material assistance to him in connection with the acquisition in the early part of 1929 by Associated Gas and Electric Company of General Gas & Electric Corporation.<sup>261</sup>

Both Harris, Forbes & Company and Halsey, Stuart & Co., Inc., altered their policy of publicly offering only conservative bonds and

<sup>258</sup> See *infra*, p. 684, *Use of Debenture Proceeds*, and pp. 690–1, *Securities Added to Portfolio in Lieu of Debenture Proceeds*.

<sup>259</sup> *Op. cit. supra*, note 6, Commission's Exhibit No. 3843.

<sup>260</sup> *Id.*, Commission's Exhibit No. 3843. In a letter dated March 19, 1929, addressed to H. C. Hopson, C. B. Stuart stated: "We sincerely appreciate the forty percent interest that we received, and I know you had a lot to do with this." Mr. Burroughs testified (*id.*, at 23475):

Q. Did you have any discussion with Mr. Hopson as to whether Halsey, Stuart & Company should take part in the underwriting of the Eastern Utilities Investing Corporation debentures?

A. You mean should be offered?

Q. Yes.

A. Naturally I would have to [ask] Halsey, Stuart whether they would take it, but I most certainly talked with Mr. Hopson about inviting Halsey, Stuart to join in the business.

Q. Did Mr. Hopson suggest it to you?

A. I don't remember who suggested it. Very probably.

Mr. Charles B. Stuart testified that Halsey, Stuart & Co., Inc. also had "written calls on all of General Gas & Electric Corporation's underwritings. \* \* \* Those were still in effect after the Associated acquired General Gas. \* \* \* My recollection is that they covered, those calls covered, all the bond financing and probably all the preferred stock financing of the underlying companies of the holding company [General Gas & Electric Corporation]." (*Id.*, at 27320.)

<sup>261</sup> *Id.*, at 27329–35. For more detailed discussion of this acquisition of control, see *infra*, pp. 673–4.

debentures early in 1929 so as to embark on a policy of publicly distributing more speculative noncollateralized debentures as well as junior securities.<sup>262</sup> The underwriting of these debentures of Eastern Utilities Investing Corporation marked the change in Harris, Forbes & Company's policy.<sup>263</sup> Halsey, Stuart & Co., Inc., had just underwritten one debenture issue of Insull Utility Investments, Inc., an investment company organized by Mr. Samuel Insull.<sup>264</sup>

Even though no property or collateral was pledged to secure the debentures of Eastern Utilities Investing Corporation, Mr. Stuart testified that at the time his firm believed these debentures were as safe an investment as the collateralized bonds which they had been handling in the past, principally because of "the tremendous diversification of their [the investment companies'] assets and the diversification of income."<sup>265</sup>

Mr. Stuart testified:<sup>266</sup>

Q. What did you consider were the factors which made the investing company debentures in your opinion as safe as the securities you had been handling in the past?

A. I think one of the principal reasons was the tremendous diversification of their assets and the diversification of income.

However, when examined on the actual diversification of the portfolio of Eastern Utilities Investing Corporation as compared with statements in his firm's offering circular, Mr. Stuart testified:<sup>267</sup>

I think anyone reading that circular would have the right to expect there was a greater diversification than there actually was.

<sup>262</sup> Id., at 23463, 23448-9, 27210-4, 27304.

<sup>263</sup> Mr. Burroughs stated (id., at 23463): "It was a little new for Harris, Forbes & Company and they didn't want to take the entire liability." Also see text supra.

Harry M. Addinsell, then a partner of his in the Harris, Forbes & Company underwriting department and now Chairman of the Executive Committee of the First Boston Corporation, testified (id., at 27210-14):

A. \* \* \* there was a radical drop from 1928 to 1929 in the amount of fixed interest obligations which Harris, Forbes & Company was underwriting \* \* \* involved in it was a change in policy on the part of the firm which had up to the later 20's \* \* \* confined its activities to handling bonds and debentures, \* \* \* and in, I think, 1929 we changed that policy and added more speculative securities.

Q. The Eastern Utilities Investing Corporation debentures weren't as safe as the securities which the public was accustomed to thinking of Harris, Forbes & Company underwriting in prior years?

A. They were a different type of security; yes.

Q. And they weren't as safe?

A. No.

\* \* \* \* \*  
Q. You would say this would you not, that Harris, Forbes & Company's reputation built up on the safer types of issues which it had recommended [in the past], helped greatly in selling the Eastern Utilities Investing Corporation debentures?

A. Well, I suppose it did.

<sup>264</sup> Id., at 27348. Mr. Stuart of Halsey, Stuart & Co., Inc., also testified (id., at 27349-50):

Q. I show you volume 2. of *American Underwriting Houses and their Issues* covering the period from November 1, 1928, to December 31, 1929, and direct your attention to Page 123, where it is stated that in January 1929, Halsey, Stuart & Co., Inc., underwrote by itself with no associates, \$6,000,000 principal amount of Insull Utility Investments, Inc. Debenture 5's A of January 1, 1949, with stock purchase warrants having an offering price of \$100, and I will ask you if that refreshes your recollection as to the date when you first underwrote a debenture issue of an investing company?

A. Yes; that is the first issue of that type we ever underwrote.

<sup>265</sup> Id., at 27350. C. B. Stuart testified that Insull Utilities Investments, Inc.'s indenture for the debentures which his firm had distributed to the public was even looser than the indenture of Eastern Utilities Investing Corporation. (Id., at 27450.)

<sup>266</sup> Id., at 27350 and 27290.

<sup>267</sup> Id., at 27356.

### 3. SPECIAL AUDIT REPORTS PREPARED FOR BANKERS' USE WITH RESPECT TO DEBENTURE ISSUE

Financial statements, including a balance sheet as at January 31, 1929, income account and list of the company's investments, were prepared by Haskins & Sells, the Associated System's auditors, for the bankers' use in connection with the sale of the debentures. These reports were kept current from January to March 1929, and were available for preparation of the prospectus. Mr. Burroughs, who was more familiar with the affairs of the company than any member of Halsey, Stuart & Co., Inc.,<sup>268</sup> testified:<sup>269</sup>

Q. Wasn't this auditor's report, Exhibit 3780 for identification, made up for the express purpose of this Eastern Utilities Investing Corporation debenture issue?

A. I feel sure it was and I feel sure it was made up so that the bankers could have in their files an audit as of the date corresponding to the statements in the circular.<sup>270</sup>

### 4. THE UNDERWRITING AGREEMENT

On March 15, 1929, the underwriting agreement between Eastern Utilities Investing Corporation, as issuer, and Harris, Forbes & Company, as banker and underwriter, was executed. By the terms of this agreement the banker purchased \$10,000,000 principal amount of the 5% gold debentures due March 15, 1954, with Class A common stock purchase warrants attached thereto, to be sold to the public at a price of 98% of their principal amount and accrued interest to date of delivery; and also secured an option to purchase the balance of the authorized issue, to wit, \$25,000,000 principal amount. Eastern Utilities Investing Corporation, over the signature of its president, H. C. Hopson, agreed to pay the bankers 4½% of the principal amount upon acceptance of the debentures and payment of the purchase price of 98% by the bankers.<sup>271</sup>

Associated Gas and Electric Securities Company, Inc., an entirely controlled subsidiary of Associated Gas and Electric Company, agreed to buy any part of the \$25,000,000 of debentures optioned to the bankers which were not taken up by them. However, this underwriting agreement never became effective because Harris, Forbes & Company and Halsey, Stuart & Co., Inc. sold the entire \$35,000,000 and exercised the option to take the entire issue.<sup>272</sup> In so doing, they obtained a gross spread or commission of 4½ points on \$25,000,000 as to which they assumed no underwriting risk.<sup>273</sup>

The price to the public was 98, with a gross commission of 4½ points to the banker,<sup>274</sup> or an anticipated gross commission of

<sup>268</sup> Id., at 27200.

<sup>269</sup> Id., at 23524-5.

<sup>270</sup> A more detailed discussion of the statements contained in that circular and the character thereof appears in *infra*, pp. 674-82, *The Offering Circular*.

<sup>271</sup> A copy of this agreement is shown in *op. cit. supra*, note 6, Commission's Exhibit No. 3771 (Part V, Item 41c).

<sup>272</sup> Id., Commission's Exhibit No. 3771, Part V, page 22. See also *id.*, at 27131.

<sup>273</sup> Id., at 23471.

<sup>274</sup> Id., at 23464 and 23471.

\$1,575,000. As previously mentioned, Halsey, Stuart & Co., Inc., was given a 40% participation in this underwriting agreement and Harris, Forbes & Company therefore received the balance of the gross commissions, almost \$1,000,000.

## 5. THE OFFERING CIRCULAR

### a. General

The debentures were offered to the public on or about March 19, 1929, shortly after the underwriting agreement was executed.<sup>275</sup>

The first draft of the circular offering \$35,000,000 of Eastern Utilities Investing Corporation debentures was probably prepared by employees of one of the Hopson service companies,<sup>276</sup> and went through many revisions at the hands of the bankers.<sup>277</sup> Evidently the bankers were considered best qualified to determine the contents of the circular because they were considered most expert in securities sales appeal.

Mr. Stix testified:<sup>278</sup>

Q. Well, the services which the bankers were supposed to be best qualified to render were the services of selling the securities; is that not right?

A. That is right.

Q. And therefore is it not true that their advice was given as to what type of securities would be most favorable to the public?

A. Yes.

Q. And as to the method in which those securities should be presented to the public?

A. Yes. They knew their own customers and they knew what type of people they were dealing with, so they were in a good position, as good if not better than Associated, to determine the type of information which should be furnished to their customers.

The proofs of the circular were distributed to the lawyers, representatives of the bankers' group, and various people in the Associated management so that, when completed, it would reflect the consensus of their ideas.<sup>279</sup>

The bankers, as well as the management, had before them a current list of the portfolio of Eastern Utilities Investing Corporation prepared by the company's management,<sup>280</sup> and also a draft of a **Haskins**

<sup>275</sup> Id., Commission's Exhibit No. 3851 indicates March 19, 1929, as the date. Mr. Burroughs testified: "I might suggest that the date of the circular will probably show the date of the offer—The letter and circular is dated March 18." (Id., at 23489.) The circular is in Commission's Exhibit No. 3771. The advertisement of the issue appeared in *The New York Times* of March 19, 1929.

<sup>276</sup> Id., at 25022-5. Cf. the usual procedure of Harris, Forbes & Company as outlined in op. cit. supra, note 46, p. 1722.

<sup>277</sup> Op. cit. supra, note 6, at 25023. Mr. Burroughs testified (id., at 23499): "\* \* \* Counsel might change it [the circular] very radically, or people in our department might change the phraseology very radically \* \* \*."

<sup>278</sup> Id., at 25022-3.

<sup>279</sup> Id., at 25023-5.

<sup>280</sup> Mr. Burroughs testified (id., at 23521): "\* \* \* we were fully advised as of the makeup of the portfolio as of the date of offering." (See also id., at 27187, 27192, and op. cit. supra, note 46, pp. 1719-20.)

& Sells audit of the company.<sup>281</sup> The circular was meticulously studied and went through many drafts.<sup>282</sup> The same circular was issued separately over the name of Harris, Forbes & Company and over the name of Halsey, Stuart & Company, Inc. The Harris, Forbes & Company copies bore the legend "We recommend these debentures for investment."<sup>283</sup> The same legend appeared over the names of both underwriters in the newspaper advertisement.

#### b. Representation as to Age of Eastern Utilities Investing Corporation

The offering circular contained the statement:<sup>284</sup>

Eastern Utilities Investing Corporation (formerly Pennsylvania Electric Corporation) was organized in 1922 under the laws of the State of Delaware. It is engaged primarily in the business of acquiring and holding for long-term investment, securities deriving their income from public utility and allied enterprises.

This statement carried the implication that the company had been an investing company for seven years (1922 to 1929)<sup>285</sup> when actually it had been such a company for only two years (1927 to 1929).<sup>286</sup> The annual report for the year 1929 gave the same impression directly. It stated:<sup>287</sup>

Eastern Utilities Investing Corporation (formerly Pennsylvania Electric Corporation) was organized \* \* \* for the purpose of acquiring and holding for long-term investment, securities deriving their income from public utility and allied enterprises.

Since Eastern Utilities Investing Corporation was not well known to the public,<sup>288</sup> the circular gave the company the semblance of a seasoned company with established investment policies. This, coupled with the current earnings statement which would indicate these policies had been successful, may have been of material aid in selling the securities. A well-seasoned investment company with a successful existence over a period of years might well present a more attractive picture to an investor than a newer organization.

<sup>281</sup> Mr. Burroughs testified (op. cit. supra, note 6, at 23500-1) :

Q. Now what additional information about Eastern Utilities Investing Corporation did Harris, Forbes obtain?

A. Oh, auditors' statements.

Q. Statements from Haskins & Sells?

A. Yes; and many statements from the company's own auditors \* \* \*.

<sup>282</sup> The proofs of the circulars were gone over some 25 or possibly 30 times. (Id., at 25023.)

<sup>283</sup> Id., Commission's Exhibit No. 3771, Part I. George D. Woods, who was Mr. Burroughs' assistant, testified (id., at 27136): "\* \* \* I don't ever remember Harris, Forbes getting out a circular without having that phrase in it."

<sup>284</sup> Ibid.

<sup>285</sup> Id., at 27177-9, 27193-5.

<sup>286</sup> This report has already indicated that the company was dormant from 1922 to 1924 and was a public utility holding company from 1924 to 1927. Mr. Burroughs testified (id., at 23314): "I had always considered that Eastern Utilities Investing Corporation started fresh when it took the name of Eastern Utilities Investing Corporation and, simply its corporate existence derived from an old charter, instead of starting with a brand new charter; a company which had been incorporated back in 1922 was revised and used. What its assets may have been, or what its activities may have been in early years, I never cared or paid any attention at all."

<sup>287</sup> Id., Commission's Exhibit No. 3771, Part I.

<sup>288</sup> Id., at 27193.



## c. Representation as to Diversification

The circular further stated:<sup>289</sup>

The Corporation diversifies its investments among the securities of a number of public-utility and allied enterprises.

As a matter of fact, at July 31, 1927,<sup>290</sup> when the company first became an investment company, over 90% of the total of the corporation's investments was in securities of the Associated Gas & Electric System.<sup>291</sup> On March 31, 1929, immediately before offering the debentures, over 65% of the Corporation's portfolio consisted of "System" securities.<sup>292</sup> And just after the circular had been issued, the proceeds of the sale of the debentures were turned over to Associated Gas and Electric Company, which turned over to Eastern Utilities Investing Corporation for this cash a list of "System" securities. These additional "System" securities raised the percentage of the portfolio invested in securities of companies in the Associated Gas & Electric System to over 84%.<sup>293</sup> Thereafter the diversification was further decreased and by the end of 1931 virtually only Associated Gas and Electric Company securities were in the portfolio of Eastern Utilities Investing Corporation.<sup>294</sup> Mr. Stix testified:<sup>295</sup>

Q. Well, it [the circular] stressed investments in companies outside of the System; is that not right?

A. It made no real distinction in the way it was presented to give the reader some idea of the percentage of Eastern Utilities Investing Corporation holdings in Associated System Companies as compared with companies that had no connection with the Associated. There was no way of telling from the circular, as I remember it now, that 70 or 75 percent of the securities or income of Eastern Utilities Investing Corporation originated from companies in the Associated System.

Q. And that was approximately the fact, was it not?

A. Yes.

The circular also set forth a list of twenty-three companies which were claimed to be:<sup>296</sup>

Some of the more important companies, from whose general operations the dividend and interest income of the Corporation is directly or indirectly derived. \* \* \*

<sup>289</sup> Id., Commission's Exhibit No. 3771, Part I.

<sup>290</sup> See supra, pp. 650-62, *Securities Received from Associated Gas and Electric Company in Lieu of Due Bill*.

<sup>291</sup> This was the date when Eastern Utilities Investing Corporation became an investment company.

<sup>292</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3805 shows the portfolio as of January 31, 1929, February 28, 1929, and March 31, 1929. As of March 31, 1929, "System" securities amounted to \$32,000,000 out of a total of \$48,000,000.

<sup>293</sup> See infra, pp. 701-2, *Portfolio in April 1929*. Harry M. Addinsell, formerly a partner of Mr. Burroughs in the underwriting department of Harris, Forbes & Company and now chairman of the Executive Committee of The First Boston Corporation, testified, "I would be surprised that the percentage was as large as that." (Id., at 27189.) He said this although later he said it was the general practice for an underwriting department to become familiar with the use to which proceeds of a proposed issue were to be put. (Id., at 27817.)

<sup>294</sup> See supra, pp. 661-2, *Investment in Associated Gas and Electric Company Securities*.

<sup>295</sup> Op. cit. supra, note 6, at 25028-9.

<sup>296</sup> Id., Commission's Exhibit No. 3771, Part I.

This list did not contain the securities of Gas and Electric Associates, although Eastern Utilities Investing Corporation had an investment in that company of \$8,400,000;<sup>297</sup> nor of Utility Management Corporation (formerly Managing and Investing, Inc.), in which Eastern Utilities Investing Corporation had an investment of \$5,000,000; nor of Consumers Construction Company, in which Eastern Utilities Investing Corporation had an investment of \$5,000,000. Mr. Addinsell, then a partner in the underwriting end of Harris, Forbes & Company, testified that the list should have included them.<sup>298</sup> The list, however, did include:<sup>299</sup>

General Gas & Electric Corporation.  
 New Jersey Power and Light Company.  
 Consolidated Gas Company of New York.  
 Edison Electric Illuminating Company of Boston.  
 United Gas Improvement Company.  
 Metropolitan Edison Company.

These companies were six well-known companies, but Eastern Utilities Investing Corporation had a total investment of only \$136,476 in these securities. In fact, Eastern Utilities Investing Corporation had no investment at all in three of these six companies up to March 31, 1929,<sup>300</sup> and never had any securities of New Jersey Power and Light Company or Metropolitan Edison Company.<sup>301</sup>

<sup>297</sup> Mr. Burroughs testified (id., at 23542-3) :

Q. How much did Eastern Utilities Investing Corporation have invested in Gas and Electric Associates?

A. \$8,400,000.

Q. Gas and Electric Associates was not mentioned in the list of companies on the circular, was it?

A. No.

Q. And yet the investment of Eastern Utilities Investing Corporation in Gas and Electric Associates was about \$8,000,000 and the investment in Consolidated Gas of New York was about \$23,000?

A. That is right, and I might point out that \$32,000,000 of cash was not mentioned here.

(N. B. The corporation did not have \$32,000,000 of cash. Mr. Burroughs evidently had in mind the debenture proceeds paid some two weeks later to Associated Gas and Electric Company by the bankers' check which, though payable to Eastern Utilities Investing Corporation, was endorsed over the day it was delivered.)

<sup>298</sup> Id., at 27192.

<sup>299</sup> Id., Commission's Exhibit No. 3771, Part I.

<sup>300</sup> Id., Commission's Exhibit No. 3805 indicates Eastern Utilities Investing Corporation's investment in these six companies as at March 31, 1929, as follows :

General Gas & Electric Corporation.....	0
New Jersey Power and Light Company.....	0
Consolidated Gas Company of New York.....	\$22, 026
Edison Electric Illuminating Company of Boston.....	96, 000
United Gas Improvement Company.....	18, 450
Metropolitan Edison Company.....	0
	<hr/> 136, 476

The total investment of \$136,476 in these six companies on the list was less than  $\frac{3}{10}$  of 1 percent of the portfolio valued at the time at about \$47,000,000 and much less than  $\frac{2}{10}$  of 1 percent of the April 3 portfolio, valued at about \$80,000,000.

Although the issuing company soon invested a majority of the debenture proceeds in stock of General Gas & Electric Corporation, the circular's reference to General Gas did not purport to be on a pro forma basis.

<sup>301</sup> Id., Commission's Exhibits No. 3771, Part VII, Table 32, and No. 3805. Mr. Burroughs' assistant, George D. Woods, testified (id., at 27152-5) :

Q. Now, the prospectus contains the list of companies which are called some of the more important companies from whose general operations the dividend and interest income of the corporation is directly or indirectly derived, isn't that right?

A. That is correct.

Q. Now, among those companies is listed Metropolitan Edison Company; the New Jersey Power and Light Company, isn't that right?

Contrary to the circular's express statement that New Jersey Power and Light Company and Metropolitan Edison Company were among "some of the more important companies, from whose general operations the dividend and interest income of the Corporation is directly or indirectly derived," the Eastern Utilities Investing Corporation never received any dividends or interest directly or indirectly from these companies. New Jersey Power and Light Company and Metropolitan Edison Company were indirect subsidiaries of General Gas & Electric Corporation,<sup>302</sup> which had just recently become a subsidiary of Associated Gas and Electric Company. If any "dividend" or "interest income" had been derived by Eastern Utilities Investing Corporation from either New Jersey Power and Light Company or Metropolitan Edison Company, it would have had to "filter" through subholding companies and through dividends on Class A stock of Associated Gas and Electric Company held by Eastern Utilities Investing Corporation. However, the two oper-

A. That is correct.

Q. Will you consult the list of investments in the audit report and see if either of those two companies were in the portfolio of Eastern Utilities Investing Corporation at January 31, 1929?

A. I don't see them.

Q. Will you refer to Exhibit Volume 8, Exhibit 3805, which has been identified as showing the portfolio of Eastern Utilities Investing Corporation at February 28, 1929, and at March 31, 1929, and state whether either of those two companies is contained in the portfolio at either of those dates?

A. I don't see them.

Q. Wouldn't you consider it misleading to the public investors to list in the prospectus preceded by the language that is there, those two companies when Eastern Utilities Investing Corporation did not have any of their securities in its portfolio?

A. Why, yes; they shouldn't have been included.

Q. The prospectus also lists United Gas Improvement Company as being one of the companies, isn't that right?

A. That is right.

Q. What was the amount of Eastern Utilities Investing Corporation's investment in United Gas Improvement Company at the end of January 1929?

A. \$19,000.

Q. Was their investment about the same at February 28th and March 31st, 1929?

A. Yes; according to these statements, it was.

Q. Don't you consider it misleading to mention a prominent company like United Gas Improvement Company in the prospectus when Eastern Utilities Investing Corporation's investment in it was only \$19,000?

A. Yes; I think the language is a little unfortunate.

Q. Edison Electric Illuminating Company of Boston is listed in the prospectus, is it not?

A. Yes; it is.

Q. What was Eastern Utilities Investing Corporation's investment in that company?

A. According to this Haskins and Sells statement, \$95,700.

Q. And the investment was the same at the end of February and the end of March 1929, is that right?

A. Yes; it was.

Q. And similarly wasn't it misleading to list that company?

A. Well, it certainly could have been made much clearer.

Q. Consolidated Gas Company of New York is listed in the prospectus, is it not?

A. Yes.

Q. And what was the amount of Eastern Utilities Investing Corporation's investment in it?

A. \$23,175.

Q. Isn't it obvious that the purpose of that list of companies in the prospectus was to impress the public with the importance of the companies in which the prospectus said Eastern Utilities Investing Corporation had investments?

A. I guess that is a fair statement. I don't know what the purpose of the thing was, unless it was that.

Q. The public investors would think from reading that list that Eastern Utilities Investing Corporation had very substantial investments in those companies, isn't that right?

A. Well, he might have had that impression. Of course, I do not want to quibble about words, but it doesn't say anything about "substantial" and maybe it is just a happenstance that Associated begins with "A", but the first name on the list is Associated.

Q. Would you approve of a prospectus containing a list like that?

A. Today?

Q. Yes.

A. No.

<sup>302</sup> Id., Commission's Exhibit No. 3820.

ating companies sent no income up the line, but capitalized it, which Mr. Burroughs said amounted to "the same thing."<sup>303</sup>

The effect of this list was to give the misleading impression that the corporation's portfolio was diversified among some of the best-known utility companies in the country and so to heighten the impression created by the preceding statement that "the corporation diversifies its investments."<sup>304</sup> Mr. Stix testified:<sup>305</sup>

A. You might conclude from this circular that Eastern Utilities Investing Corporation had securities in each of the companies listed.

Q. You could not conclude anything else, could you?

A. Well, I suppose if you were not as familiar as I am with it, you probably would not conclude anything else from it. I think that was set up in very poor form.

Q. And in a very misleading form; is that not right?

A. I think it is open to complete misunderstanding as to precisely what the facts were.

Q. The New Jersey Power and Light Company and the Metropolitan Edison Company were well known in the mind of the public, were they not?

A. I believe they were.

Q. The circular would give the impression that Eastern Utilities Investing Corporation had investments in those companies, whereas actually it did not have any such investments; is that not right?

A. Well, it did not up to March 31, but I wonder whether this list here was not intended to give effect to the investments which it would have when the securities were sold and paid for.

Q. Mr. Burroughs testified the circular was issued on March 18; it does not say that the companies it lists were after giving effect to future acquisitions, does it?

A. No; it does not.

Q. So the circular was strictly misleading, was it not?

A. Well, I think it could mislead a person.

Nor was stock of New Jersey Power and Light Company and Metropolitan Edison Company thereafter acquired.<sup>306</sup>

<sup>303</sup> Op. cit. supra, note 46, p. 2066.

<sup>304</sup> Mr. Woods testified (op. cit. supra, note 6, at 27158-9, 27161, and 27163):

Q. Will you look at Exhibit 3842, a wire dated March 13, 1929, that is a photostat of a wire which you personally sent to someone in the Chicago office, isn't that right?

A. That is right.

Q. Will you read that into the record?

A. This is to "R. M. P., Chicago; referring to 16 to J. A. L., approximately \$5,000,000 on the basis of present markets of Associated Gas and Electric Class A is included in Eastern Utilities assets of \$81,000,000 stop. This is confidential stop. As a matter of fact, this is a temporary investment as the management of Eastern Utilities does not conceive it to be that company's policy to invest in securities of Associated Company excepting in a very limited way stop. Primary object of Eastern Utilities is to invest in minorities of other large and important utility systems."

Q. \* \* \* What was the basis for your making that statement?

A. I must have gone in and talked to Burroughs, or I must have gotten it from the company.

Q. As a matter of fact of the portfolio which Eastern Utilities Investing Corporation had immediately after the investment of its debenture proceeds, practically three-fourths of its portfolio was in securities of Associated Gas and Electric Company or its newly acquired subsidiary, General Gas and Electric Corporation, isn't that right?

A. I didn't get that.

(The reporter thereupon read the pending question as recorded.)

The WITNESS. Yes.

<sup>305</sup> Id., at 24692-3.

<sup>306</sup> See supra, pp. 677-8.

Mr. Burroughs of Harris, Forbes & Company admitted that he would not now think of publishing such a list without including the amounts invested in each company.<sup>307</sup> His partner, Harry M. Adkinsell, testified that it would now be considered bad practice.<sup>308</sup> Mr. Burroughs' assistant admitted that it was misleading.<sup>309</sup> Mr. Stuart of Halsey, Stuart & Co., Inc., testified that the list must have been "carelessly prepared," but denied it could have been done intentionally;<sup>310</sup> and, as mentioned above, he admitted that "anyone reading that circular would have the right to expect there was a greater diversification than there actually was."<sup>311</sup>

#### d. Representation as to Primary Purpose of Eastern Utilities Investing Corporation

Referring further to Eastern Utilities Investing Corporation, the circular stated that:<sup>312</sup>

Its primary business is the investment of the proceeds from the sale of its capital securities, and the reinvestment and/or disbursement to its security holders of the income received.

In reality the primary purpose for raising the funds by the sale of the debentures was to aid Associated Gas and Electric Company in financing its acquisition and carrying of stocks in utility companies. Mr. Stix testified:<sup>313</sup>

Q. Is it a correct statement to say that the financing in 1929 by the Eastern Utilities Investing Corporation, when this \$35,000,000 issue of bonds was made, was made for the benefit of Associated Gas and Electric Company?

A. Well, I do not know whether you might say that that was the entire thing. It did benefit the Associated Gas and Electric Company, and raising money for the Associated Gas and Electric Company was one of the purposes of the financing.

Mr. Stix had testified:<sup>314</sup>

A. \* \* \* I would be inclined to say Utility Clearing Corporation probably paid some expense of Eastern Utilities Investing Corporation without rebilling them to Eastern Utilities Investing Corporation.

Q. Why?

A. On the principle, I believe, in that the charge should go to the person who got the benefit, and inasmuch as the Associated companies got all of the benefit from Eastern Utilities Investing Corporation financing, they should pay the expense of keeping alive the thing that made it possible for them to get the money.

Apparently, a plan had been formulated by the controlling persons, which was subsequently consummated, to use Eastern Utilities Investing Corporation to hold minority interests in various companies until such time as those in control desired them to be trans-

<sup>307</sup> Op. cit. supra, note 6, at 23539-40.

<sup>308</sup> Id., at 27190.

<sup>309</sup> Id., at 27153-4.

<sup>310</sup> Id., at 27355-6, 27362.

<sup>311</sup> Id., at 27356.

<sup>312</sup> Id., Commission's Exhibit No. 3771, Part I.

<sup>313</sup> Op. cit. supra, note 41, p. 1109.

<sup>314</sup> Op. cit. supra, note 6, at 24778-9. Also see id., at 25041, and infra (pp. 686-7) in respect to Eastern Utilities Investing Corporation's investment of about \$26,000,000 in General Gas & Electric Corporation.

ferred to some other company or companies in the "System." The original plan was for Eastern Utilities Investing Corporation to retain these minority interests until the Associated System should have acquired control of the companies involved. However, these minority interests were gradually removed from the portfolio of Eastern Utilities Investing Corporation beginning about April 1929 even though the "System" had not acquired control. And Eastern Utilities Investing Corporation was used to carry securities of General Gas & Electric Corporation even though the "System" had previously acquired control of that corporation.<sup>315</sup> The plan for using Eastern Utilities Investing Corporation for this object was not referred to in the circular nor is there any evidence that the minority stockholders were ever apprised of any such policy.<sup>316</sup> Mr. Stix testified:<sup>317</sup>

Q. You are quite clear aren't you that that object of Eastern Utilities Investing Corporation holding minority interests for Associated Gas & Electric Company System was not conveyed to minority stockholders of Eastern Utilities Investing Corporation?

A. I won't say that it never was. I will say that I don't recall that it ever was.

Q. You usually keep pretty familiar with things all over your system, don't you?

A. I try to.

<sup>315</sup> Id., at 23332 and Commission's Exhibit No. 3771, Part VII (Tables 32 and 33).

<sup>316</sup> Mr. Stix testified (id., at 23328-9):

Q. And it wasn't planned that Eastern Utilities Investing Corporation would be run exclusively as an investment trust, was it?

A. Why, yes; that was an investment trust function.

Q. You mean it was an investment trust to help the Associated System finance the acquisition of control of utility properties?

A. The two were so interdependent upon each other you really can't make any distinction between them.

Q. They were interdependent upon each other in the meetings of the directors of Eastern Utilities Investing Corporation?

A. Absolutely.

Q. Did any prospectus issued by Eastern Utilities Investing Corporation or any letter sent to the stockholders of Eastern Utilities Investing Corporation state that one of the purposes of Eastern Utilities Investing Corporation was to finance acquisition of control by Associated System of public utility properties?

A. No; because that is only part of the facts.

Mr. Burroughs stated that he realized that the securities might well be mistaken for "investment trust" securities and that he cautioned the salesmen against offering the securities "as an investment trust." But the circular did not include such a warning. Whether this warning to his salesmen was repeated to customers is not disclosed. However, it should be recalled Eastern Utilities Investing Corporation was designed to take advantage of the popularity of the investment trust idea in the United States and so tap a new source of capital. (Id., at 23517. Cf. id., Commission's Exhibit No. 3851, written instructions to Harris Forbes salesmen.) Mr. Burroughs testified (id., at 23515): "I recall very distinctly when these Eastern Utilities Investing Corporation debentures were offered. I made a talk to our sales organization, telling them about the company, and I remember telling them that 'This is not an investment trust in the ordinary sense. It must not be offered as an investment trust. It is an investment company that may have a much larger block of securities than you would expect to find in an investment trust.'" (See note 304, supra.) Even the warning that Eastern Utilities Investing Corporation might have "a much larger block of securities than you would expect to find in an investment trust" scarcely indicated that 84½% of the debenture proceeds would immediately be invested in General Gas & Electric Corporation and its subsidiaries and 15½% (the balance) in Associated Gas and Electric Company. (See *infra*, pp. 690-1, *Securities Added to Portfolio in Lieu of Debenture Proceeds*.) This warning was even less effective, since the circular said the company "diversifies its investments," a statement which Mr. Burroughs admitted would carry material weight with the investing public. (Op. cit. supra, note 6, at 23517, 23519.)

<sup>317</sup> Id., at 23333.

e. Representation as to Control of Eastern Utilities Investing Corporation

Although the circular disclosed that all of the members of the board of directors of Eastern Utilities Investing Corporation were "connected in either an official or advisory capacity with the management of the Associated Gas & Electric System,"<sup>318</sup> it did not explicitly disclose that this "System" controlled the investment company. This quoted statement might give the impression that individuals connected with the "System" would give Eastern Utilities Investing Corporation the benefit of their experience and knowledge. It is doubtful whether the circular disclosed that these individuals would manage Eastern Utilities Investing Corporation as if that company were a department of the "System."

6. PURCHASE WARRANTS FOR EASTERN UTILITIES INVESTING CORPORATION CLASS A STOCK: OPTIONS TO ASSOCIATED GAS AND ELECTRIC COMPANY

Each \$1,000 principal amount of debentures had attached thereto a nondetachable stock purchase warrant entitling the holder to purchase 20 shares of Eastern Utilities Investing Corporation Class A stock at \$15 per share.<sup>319</sup> As previously stated,<sup>320</sup> Eastern Utilities Investing Corporation had issued 100,000 shares of Class A stock to Associated Gas and Electric Securities Company, Inc. on July 31, 1927, for 50¢ per share; but that fact was not disclosed in the offering circular.

On August 8, 1928, an option was given to Associated Gas and Electric Company to purchase 400,000 shares of the Class A stock at \$5 per share. This option was completely exercised in March 1929 just prior to the debenture issue,<sup>321</sup> but that fact was not disclosed in the offering circular.

Furthermore, in March 1929 options were given to Associated Gas and Electric Company to purchase 265,000 shares of Class A stock at \$10 per share and 140,000 shares of the same stock at \$15 per share, the options being completely exercised in March 1929 and August 1929, respectively.<sup>322</sup> Neither the existence of these two options nor the fact that one of these options had been exercised at \$10 per share a short time before the offering of the debentures was disclosed in the offering circular.

Thus Eastern Utilities Investing Corporation disposed of 905,000 shares of its Class A stock to companies in the Associated System for a total of approximately \$6,800,000 or an average price of about \$7.50 per share. The exercise of all the purchase warrants attached to the debentures sold the public would have taken up 700,000 shares at \$15 per share or \$10,500,000. No disclosure in the circular was made of any of these facts. The circular dated March 18, 1929, and published in connection with the debenture issue stated:<sup>323</sup>

<sup>318</sup> Id., Commission's Exhibit No. 3771, Part I.

<sup>319</sup> Id., Commission's Exhibit No. 3771, Part V, Item 41 (c).

<sup>320</sup> See *supra*, p. 664.

<sup>321</sup> Op. cit. *supra*, note 6, Commission's Exhibit No. 3771, Part V, Item 45.

<sup>322</sup> *Ibid.*

<sup>323</sup> Id., Commission's Exhibit No. 3771.

Cash and investments of the Corporation \* \* \* after deducting indebtedness and preferred stocks, at liquidation value, are approximately \$10 per share on the 1,265,000 shares of Class A and Class B Common Stocks to be outstanding.

Despite this indication that the value of the Class A stock was \$10 per share, Associated Gas and Electric Company just a few days before had exercised its option to purchase Eastern Utilities Investing Corporation Class A stock at \$5 per share.<sup>324</sup>

Mr. Burroughs, speaking of these purchases of Class A stock by Associated Gas and Electric Company, testified:<sup>325</sup>

Certainly it was its hope to market the stock which it had bought at a profit to it, there is no question about that.

Associated Gas and Electric Company did sell to the public through Pyncheon and Company, a brokerage concern, some of that Class A stock which had cost it an average of \$7.50 per share and made a substantial profit on these sales.<sup>326</sup>

Shortly after the exercise of those options in March 1929, the price of Eastern Utilities Investing Corporation Class A stock on the Boston Stock Exchange fell from about \$35 per share<sup>327</sup> to less than half that price.<sup>328</sup> Although it was said the listing of the Class A stock of Eastern Utilities Investing Corporation on the Boston Stock Exchange was maintained primarily for the purpose of exempting the proposed debentures of the same company from requirements of Blue Sky Laws in other states,<sup>329</sup> and that consequently the market price of \$35 was a nominal one, the decline of 50% in the price is indicative of the effect that the exercise of the options had on the interest of the public holders of Eastern Utilities Investing Corporation Class A stock.

Both before and after the debentures were offered Pyncheon and Company was actively dealing in the Eastern Utilities Investing Corporation's Class A stock.<sup>330</sup> The stock had been listed on the Boston Stock Exchange and was selling around \$16.00 per share at the time of the debenture offer.<sup>331</sup> By July 1, 1929, the stock was quoted at 23 bid, 24

<sup>324</sup> See *supra*, p. 682.

<sup>325</sup> *Op. cit. supra*, note 46, p. 1999.

<sup>326</sup> *Id.*, at 1906, 1917, and 1999.

<sup>327</sup> *Op. cit. supra*, note 6, Commission's Exhibit No. 3842. A telegram dated March 18, 1929, sent over the private wire of Harris, Forbes & Company from G. D. Woods (Mr. Burroughs' assistant in the New York office) to "RMP" in the Chicago Office, stated (*ibid.*): "Eastern Utilities up until within past few weeks had 100,000 shares each of Class A and Class B stock outstanding and in addition there were rights for the purchase of 400,000 additional shares of each outstanding. Stop. When this situation obtained there were 25,000 of the outstanding Class A shares listed on the Boston Exchange and it was these shares that your client found quoted in the neighborhood of 35. Stop. In conjunction with the present financing all warrants for the purchase of A and B stock have been exercised and inasmuch as these warrants were at a comparatively low price the market value of the outstanding shares was correspondingly decreased. Stop. The present quotation in the neighborhood of 16½ is firm and active. Stop. The quotation on the Boston Stock Exchange was neither but it was predicated on the very few shares outstanding and was maintained primarily for blue-sky purposes." (See also *op. cit. supra*, note 46, p. 1868. Mr. Burroughs testified (*id.*, at 1997): "In fact, I think that market did go to \$35.")

<sup>328</sup> The market price of Eastern Utilities Investing Corporation Class A was quoted on March 11, 1929, at 14½ bid and 15½ asked. (*Op. cit. supra*, note 46, at 1770-2. See also *op. cit. supra*, note 6, at 27171-5.)

<sup>329</sup> *Op. cit. supra*, note 6, at 27167-71, and Commission's Exhibit No. 3842, Item 7.

<sup>330</sup> *Id.*, at 23479.

<sup>331</sup> *Id.*, Commission's Exhibit No. 3842, Item 7.



asked.<sup>332</sup> Probably the arbitrage advantage aided the sale of the debentures<sup>333</sup> and indicated a large potential profit for the Associated Gas and Electric Company and the Associated Gas and Electric Securities Company, Inc., at the expense of investors in Eastern Utilities Investing Corporation. Actually, however, stock prices in general had already dropped before January 1, 1930, so that when the warrants became exercisable (i. e., between January 1, 1930, and December 31, 1934) not many shares were taken up by the public.

## 7. USE OF DEBENTURE PROCEEDS

The net proceeds from the sale of the debentures of Eastern Utilities Investing Corporation amounted to \$32,812,500, computed as follows: <sup>334</sup>

	<i>Aggregate amount</i>	<i>Per \$100 unit</i>
Principal amount-----	\$35, 000, 000	\$100. 00
Discount-----	700, 000	2. 00
Price to public-----	34, 300, 000	98. 00
Accrued interest-----	87, 500	. 25
Price plus accrued interest-----	34, 387, 500	98. 25
Gross underwriting spread to bankers-----	1, 575, 000	4. 50
Net proceeds to Eastern Utilities Investing Corporation-----	32, 812, 500	93. 75

### a. Delivery to Associated Gas and Electric Company of Proceeds of Sale of Eastern Utilities Investing Debentures

On April 3, 1929, the bankers paid \$34,387,500 to Eastern Utilities Investing Corporation in the form of a check drawn to the order of that corporation.<sup>335</sup> However, Eastern Utilities Investing Corporation did not deposit this check in its bank account, but on the same day endorsed the check to Associated Gas and Electric Company in whose account it was deposited.<sup>336</sup> There is no entry in the cash account of Eastern

<sup>332</sup> Op. cit. supra, note 46, p. 1993.

<sup>333</sup> Mr. Burroughs testified (op. cit. supra, note 6, at 23481): "It [a warrant] gives the person a speculative chance in addition to his investment, and along in 1929 investors were unwilling to buy a fixed income security. They were all stockminded."

<sup>334</sup> Id., Commission's Exhibit No. 3772, Item 4.

<sup>335</sup> Op. cit. supra, note 41, p. 813.

<sup>336</sup> Id., at 813-4. Op. cit. supra, note 6, Commission's Exhibit No. 3806 shows cash statements of Associated Gas & Electric System from April 2, 1929, to April 23, 1929. The statement for April 3, 1929, shows the receipt by Associated Gas and Electric Company from Eastern Utilities Investing Corporation through Associated Utilities Investing Corporation of \$34,387,500 and the payment to Harris, Forbes & Company of \$1,575,000 or a net amount received by Associated Gas and Electric Company of \$32,812,500.

Carl J. Batter, a certified public accountant employed by and working entirely under the direction of Charles M. Trammel (a law associate of H. C. Hopson), but who is on the pay roll of H. C. Hopson and Company, testified as follows (op. cit. supra, note 41, pp. 618 and 813-4): "\* \* \* The check was endorsed to Associated Gas and Electric Company and the books record Associated Gas and Electric Company for Associated Utilities Investing Corporation \* \* \* the parent of Eastern Utilities Investing Corporation \* \* \* [which] means in conformity with the practice in the Associated System of carrying the open accounts between parent and child that Associated Utilities Investing

Utilities Investing Corporation to indicate that it received any such cash.<sup>337</sup> As Mr. Stix testified:<sup>338</sup>

Q. If Eastern Utilities Investing Corporation received the cash, it would have been shown in the cash account, would it not?

A. It should have been.

On the same day Associated Gas and Electric Company placed \$34,000,000 of the \$34,387,500 on call with The New York Trust Company.<sup>339</sup> On the same day Associated Gas and Electric Company had called a call loan in the amount of \$1,600,000, and purchased a New York Trust Company cashier's draft for \$1,575,000 to Harris, Forbes & Company in payment of the underwriting fees on the debenture issue.<sup>340</sup> Although this draft was payable direct to the banking firm, the books of Eastern Utilities Investing Corporation indicate that Eastern Utilities Investing Corporation borrowed that sum from Associated Gas and Electric Company and paid it to Harris, Forbes & Company, repaying this amount to Associated Gas and Electric Company the same day.<sup>341</sup> The check and the entries together apparently indicate that the bankers' commission was paid by Associated Gas and Electric Company for the account of Eastern Utilities Investing Corporation, and that the check for the gross proceeds which Eastern Utilities Investing Corporation turned over to Associated Gas and Electric Company included repayment of the advance.

The important fact, however, is that on April 3, 1929, Eastern Utilities Investing Corporation received, instead of cash, a list of securities.<sup>342</sup> as shown later in this report. The cash which went to Associated Gas and Electric Company on that date increased that company's cash position by more than \$32,800,000, and made available those funds for the financing of its pending transactions.<sup>343</sup>

Mr. Stix stated that "inasmuch as the Associated companies got all of the benefit from Eastern Utilities Investing Corporation's financing they should pay the expense of keeping alive the thing that made it possible for them to get the money."<sup>344</sup>

The disposition by Associated Gas and Electric Company of part of the cash proceeds of the sale of the Eastern Utilities Investing Corporation debentures was traced at the public examination,<sup>345</sup> particularly (a) the part used in connection with the purchase of control of General Gas & Electric Corporation by Associated Gas and Electric Company and (b) the part advanced to a security subsidiary of Associated Gas and Electric Company which was trading in the securities of the parent.

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Corporation, being the parent of Eastern Utilities Investing Corporation, any transactions between Associated Gas and Electric Company and Eastern Utilities Investing Corporation would pass through the Associated Utilities Investing Corporation account."

<sup>337</sup> Op. cit. supra, note 6 at 25075-7 and Commission's Exhibit No. 3809.

<sup>338</sup> Id., at 25076.

<sup>339</sup> Id., at 23604 and Commission's Exhibit No. 3806.

<sup>340</sup> Ibid.

<sup>341</sup> Id., at 23594 and Commission's Exhibit No. 3781.

<sup>342</sup> Id., at 25077 and Commission's Exhibit No. 3772, Item 4.

<sup>343</sup> Id., at 23602-3.

<sup>344</sup> Id., at 24779.

<sup>345</sup> Id., Commission's Exhibit No. 3806 and infra.

b. Use of Part of Proceeds by Associated Gas and Electric Company to Pay for Control of General Gas & Electric Corporation

In February 1929, shortly before the public offering of the Eastern Utilities Investing Corporation debentures on March 19, 1929, the Associated System had contracted to purchase control of General Gas & Electric Corporation for \$50,000,000 in cash from the W. S. Barstow & Company interests.<sup>346</sup>

The debentures of W. S. Barstow & Company, issued in 1927, were supported by a pledge of collateral consisting of a majority of the voting stock of General Gas & Electric Corporation, the release of which the indenture prohibited without the consent of Halsey, Stuart & Co., Inc., which had underwritten the debentures.<sup>347</sup> Although the contract for the purchase by the Associated System of the control stock of General Gas & Electric Corporation was executed February 5, 1929, it was not until after Halsey, Stuart & Co., Inc., had received a 40% participation in the Eastern Utilities Investing Corporation debenture financing that that firm was officially requested to<sup>348</sup> and did consent to the substitution of the securities of the Associated Gas and Electric Company as collateral for the Barstow debentures, in lieu of the control stock of General Gas & Electric Corporation.<sup>349</sup> In that manner the control stock of General Gas & Electric Corporation was released, without encumbrance, to the Associated Gas & Electric System which Mr. Hopson controlled. A final payment of \$10,000,000 was due on this contract for the purchase of the control of General Gas & Electric Corporation, and the Associated had to raise this cash. The method adopted manifestly was to cause Eastern Utilities Investing Corporation to offer its debentures to the public. Mr. Stix, when examined with respect to the General Gas & Electric Corporation, stated:<sup>350</sup>

Q. What was the reason for putting into Eastern Utilities Investing Corporation about \$26,000,000 of General Gas securities out of a total of about

<sup>346</sup> Id., Commission's Exhibits Nos. 3801 and 3839. Journal voucher 2-11 of Associated Gas & Electric Co. (Del.) reads: "To record the payment of \$10,000,000 in cash being the initial payment on account of a contract February 5, 1929, between the Associated Gas & Electric Company stockholders and stockholders of Barstow Securities Corporation and W. S. Barstow & Co., Inc."

<sup>347</sup> Id., Commission's Exhibit No. 3843. The agreement of September 23, 1927, between W. S. Barstow & Company and Halsey, Stuart & Co., Inc., required (page 2) the deposit of "102,441 shares of the common stock Class B, of General Gas & Electric Corporation." The indenture dated as of October 1, 1927, between W. S. Barstow & Company and The Chase National Bank of the City of New York, as Trustee, provided in Article III, Section 8 (b) that W. S. Barstow & Company, so long as any of its debentures were outstanding, would keep on deposit and pledge with the trustee at all times a majority of the voting stock of General Gas & Electric Corporation unless Halsey, Stuart & Co., Inc., should waive compliance with this provision or consent to the release of said stock. (Ibid.)

<sup>348</sup> Id., Commission's Exhibit No. 3863.

<sup>349</sup> Photostatic copy of a letter dated March 25, 1929, from Associated Gas and Electric Company to Halsey, Stuart & Co., Inc., evidencing a request of Halsey, Stuart & Co., Inc.'s, consent to the release of the Class B common stock of General Gas & Electric Corporation from the lien of the deposit agreement with respect to the debentures of W. S. Barstow & Company. (Derived from supplementary information supplied the Commission by Halsey, Stuart & Co., Inc. See also op. cit. supra, note 6, Commission's Exhibit No. 3843.)

<sup>350</sup> Op. cit. supra, note 6, at 25041.

\$32,800,000 put in the Eastern Utilities Investing Corporation at the time of its debenture issue?

A. There was either one of two purposes, and perhaps both. In the first place, there was a very substantial amount of General Gas securities in the portfolio of the Associated which it preferred not to sell but which had certain, or represented certain, credit resources. That would be one way of being able to realize on those credit resources. In the second place the proceeds from the sale of the Eastern Utilities Investing Corporation debentures went to a substantial extent to continue the purpose of General Gas. So they seemed to naturally flow together.

Most of the \$10,000,000 last payment on the contract came from the \$32,812,500 proceeds of the sale of Eastern Utilities Investing Corporation's debentures turned over to the "System." After being examined in detail concerning the daily cash statements of Associated Gas and Electric Company from April 2 through April 19, 1929, Mr. Stix testified:<sup>351</sup>

Q. And what do the details show?

A. That the \$10,000,000 which was disbursed to E. Lovett West and William Buchsbaum was in payment of notes due April 19, 1929, re: Barstow agreement.

Q. So, was not the final payment on the Barstow purchase made with funds, the majority of which were from the Eastern Utilities Investing Corporation debentures?

A. Yes.

c. Use of Part of Proceeds by Associated System to Finance Trading in Associated Stock

In addition, Associated Gas and Electric Company used part of the proceeds of the sale of the Eastern Utilities Investing Corporation debentures to finance a market operation in the Class A common stock of Associated Gas and Electric Company. Associated Gas and Electric Company advanced \$3,175,000 to Associated Gas and Electric Securities Company, Inc., its wholly-owned securities agent, and part of these funds came from the Eastern Utilities Investing Corporation debenture proceeds.<sup>352</sup>

Mr. Stix testified:<sup>353</sup>

Q. Would that not lead you to say that the majority of the \$3,175,000 that was advanced by Associated Gas and Electric Company to Associated Gas and Electric Securities Company came from the proceeds of the Eastern Utilities Investing Corporation debentures?

A. I think so.

The funds which went into Associated Gas and Electric Securities Company, Inc., were used principally for trading in the Class A stock of Associated Gas and Electric Company. Mr. Stix at first testified that Associated Gas and Electric Securities Company, Inc., had bought "at least 30%" of the shares of Class A stock of Associated Gas

<sup>351</sup> Id., at 24706.

<sup>352</sup> Id., at 24710 and 24734. The cash statements of Associated Gas and Electric Company were so numerous and complicated that the specific disposition of the remaining proceeds was not completely traced.

<sup>353</sup> Id., at 24710.

and Electric Company traded on the New York Curb Exchange during the four months under discussion. His testimony was as follows: <sup>354</sup>

Q. Would you not now say that Associated Gas and Electric Securities Company did buy during December 1928 through April 1929 at least 30 percent of the shares (of Class A stock of Associated Gas and Electric Company) which you found as a result of your investigation to have been traded in on the New York Curb market?

A. I think that is a fair assumption.

However, when confronted with a schedule of purchases and sales of Associated Gas and Electric Company Class A stock by its subsidiary, Associated Gas and Electric Securities Company, Inc., Mr. Stix admitted that during the five months ending April 30, 1929, Associated Gas and Electric Securities Company, Inc., purchased 761,500 shares of this Class A stock on the New York Curb, or 84.3% of the 903,800 shares traded in on that exchange during that period.<sup>355</sup> On the

<sup>354</sup> Id., at 24727.

<sup>355</sup> Id., at 24713-4, and Commission's Exhibit No. 3808. See also op. cit. supra, note 103, Part 64, pp. 711 and 715. Commission's Exhibit No. 3808 reads as follows:

*Associated Gas & Electric Securities Company*

*[Comparison of purchases of Class A stock of Associated Gas & Electric Co. with total volume of trading in New York Curb market]*

Date	Total volume	Purchases by Associated Gas & Electric Securities Co.	Market price	
			Low	High
December 1928.....	43,600	30,800	47	49 $\frac{1}{4}$
January 1929.....	276,300	205,000	49 $\frac{1}{4}$	58 $\frac{3}{8}$
February 1929.....	216,500	167,800	56 $\frac{1}{8}$	61 $\frac{1}{8}$
March 1929.....	171,000	181,500	60	61 $\frac{1}{8}$
April 1929.....	196,400	176,400	55 $\frac{1}{8}$	60 $\frac{1}{8}$
Total.....	903,800	761,500	-----	-----

In this connection, Mr. Stix testified (op. cit. supra, note 6, at 26032-4):

Q. Can you state that the amount of Associated Gas and Electric Securities Company's purchases in the market as shown by Exhibit 3808, is correct for the months covered by that exhibit?

A. Well, without checking the figures I could not say that they were correct. I have no reason to believe that they are not correct.

Q. I thought you were going to have a check made. However, you feel that they are at least substantially correct?

A. As to the trading on the New York Curb market by Associated Gas and Electric Securities Company, Inc. I think this is correct.

Q. Just comparing the purchases by Associated Gas and Electric Securities Company on the Exchange with the total transactions on the Exchange itself, as shown by Exhibit 3808, we arrived the other day at a percentage of 84 $\frac{1}{4}$ , as I remember.

A. That is correct.

By Mr. Magill [Counsel appearing on behalf of the witness and of Eastern Utilities Investing Corporation]:

Q. Do you think that this is a correct comparison of purchases of Class A stock of Associated Gas and Electric Company with the total volume of trading on the New York Curb market?

A. I think it probably is as accurate as you can get those kinds of figures.

Q. Do you consider odd-lot trading as a part of the trading of the New York Curb market?

A. I don't know. If you were to ask me just what the trading was on the New York Curb market, those are the figures I would give you. I would not give you the odd-lot trading, but they are interrelated. I suppose, technically, when you talk

other hand, Associated Gas and Electric Securities Company, Inc., would sell the Class A stock off the market through customer solicitation and local dealers.

While Associated Gas and Electric Securities Company, Inc., was buying 84.3% of the shares of Associated Gas and Electric Company Class A stock traded in on the New York Curb, the market price of that stock rose from a low of \$47 in December 1928 to a high of over \$60 in March and April 1929.<sup>356</sup> During part of this period, Associated Gas and Electric Company was advancing cash obtained from sale of the Eastern Utilities Investing Corporation debentures to the subsidiary securities company which was making these large purchases of Class A stock.

Eastern Utilities Investing Corporation was caused to purchase 77,500 shares of the Class A stock of Associated Gas and Electric Company on April 3, 1929 (the date when Associated Gas and Electric Company received the proceeds of the sale of the debentures) and an additional 121,500 shares later in the same month.<sup>357</sup> Part of the proceeds of the debenture issue of Eastern Utilities Investing Corporation therefor was used to finance the market operation in the Class A stock of Associated Gas and Electric Company which patently resulted in higher market prices for that stock, and two blocks of this stock were "sold" Eastern Utilities Investing Corporation at those higher prices,<sup>358</sup> one of the blocks being in partial discharge of the obligation of Associated Gas and Electric Company to the investment company in connection with the transfer to Associated Gas and Electric Company of the proceeds of the public sale of the investment company debentures.

#### d. Large Call Loans Consisting of Proceeds of the Debenture Issue

The daily cash statements seem to indicate that both the payments of \$24,450,000 by Associated Gas and Electric Company on April 8, 1929, to General Gas & Electric Corporation<sup>359</sup> and \$10,000,000 to

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about trading on the New York Curb Exchange you talk about just what goes through the machinery of the New York Curb Exchange.

Mr. MAGILL. No objection to the receipt of the document in evidence subject to the qualifications of the witness.

In December 1928, Associated Gas and Electric Securities Company, Inc., inaugurated a plan for the redistribution of reacquired Associated Gas and Electric Company Class A stock and for the distribution of new shares of such stock through local dealers and direct sales. These transactions were not executed on the New York Curb Exchange. Class A stock was also distributed as dividends and in exchange for various securities of subsidiaries. In this way, 7,100,000 shares of Associated Gas and Electric Company Class A stock were sold or otherwise distributed to investors during 1929. (Id., at 24734-9.)

<sup>356</sup> Id., at 2471-4 and note 355, supra.

<sup>357</sup> For more detailed discussion of the transfer of this Class A stock to Eastern Utilities Investing Corporation, see *infra*, pp. 691-2.

<sup>358</sup> *Op. cit. supra*, note 6, Commission's Exhibit No. 3771, Part VII, Table 32; see also succeeding section.

<sup>359</sup> Paid in connection with a new issue of General Gas & Electric Corporation securities, but nearly all returned the same day to Associated Gas and Electric Company in payment for securities. (Id., Commission's Exhibits Nos. 3806, 3807, and 3802.)

E. Lovett West and William Buchsbaum, the principal stockholders of General Gas & Electric Corporation, were made with the proceeds of \$34,000,000 which Associated Gas and Electric Company had on call with the New York Trust Company.<sup>360</sup> And "practically all" of the call loan itself consisted of the proceeds of the Eastern Utilities Investing Corporation debenture issue. Mr. Stix testified:<sup>361</sup>

Q. So that there is no doubt, is there, that the proceeds of the debenture issue which Associated Gas and Electric Company had received from Eastern Utilities Investing Corporation on April 3 were the same day included in an amount put with The New York Trust Company on call?

A. Well, I will say there is no doubt that at least a substantial amount of the money that came from the sale of the Eastern Utilities Investing Corporation debentures went into The New York Trust Company and was put on call, and perhaps all of it. Of course, it is difficult to earmark each one after once it goes into a bank account.

Q. And, certainly, at least all the Eastern Utilities Investing Corporation debenture proceeds, except \$2,554,767.14, went to The New York Trust Company and was put on call, isn't that right?

A. I would say practically all of the money, and perhaps all of it.

Q. When you say "practically" would you mean within how many dollars of the total amount of the Eastern Utilities Investing Corporation debenture proceeds?

A. Within \$2,000,000.

Out of a total amount of \$43,700,000 out on call for Associated Gas and Electric Company as of April 3, 1929, \$35,400,000 was on call with The New York Trust Company.<sup>362</sup> It will be remembered that H. C. Hopson had suggested The New York Trust Company as the depository of Eastern Utilities Investing Corporation,<sup>363</sup> and this trust company was the trustee of the Eastern Utilities Investing Corporation debenture issue from which Associated Gas and Electric Company had obtained the money which was placed on call.

## 8. SECURITIES ADDED TO PORTFOLIO IN LIEU OF DEBENTURE PROCEEDS CONSISTING OF ISSUES OF ASSOCIATED GAS AND ELECTRIC COMPANY OR ITS SUBSIDIARIES

As previously stated, Eastern Utilities Investing Corporation in lieu of receiving the cash proceeds from the public distribution of its debentures was caused to accept a list of securities from the Associ-

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<sup>360</sup> Id., at 23612-3 and Commission's Exhibit No. 3806.

<sup>361</sup> Id., at 23604-5.

<sup>362</sup> Id., at 23601 and Commission's Exhibit No. 3806.

<sup>363</sup> See supra, p. 638, *New Transfer Agents and Depositories*.

ated Gas and Electric Company. The securities so received on April 3, 1929, were as follows:<sup>364</sup>

Issuer	Class	Shares	Price per share	Total	Percent
General Gas & Electric Corporation.....	B common <sup>a</sup> .....	150,000	\$95	\$14,250,000	43.4
Do.....	\$8 pfd. A.....	33,719	140	4,720,657	14.4
Do.....	\$7 pfd. B.....	28,051	120	3,366,120	10.3
Do.....	A common.....	24,000	90	2,160,000	6.6
Do.....	\$7 pfd. A.....	16,221	120	1,946,460	5.9
Subtotal.....				26,443,237	80.6
Broad River Power Co. <sup>b</sup> .....	\$7 pfd.....	5,878	110	646,580	2.0
Florida Public Service Co. <sup>b</sup> .....	\$7 pfd.....	5,509	110	605,990	1.8
Subtotal.....				27,695,807	84.4
Associated Gas & Electric Co.....	A common.....	77,500	57	4,417,500	13.5
Do.....	\$5 pfd.....	7,778	90	700,020	2.1
Total.....				32,813,327	100.0

<sup>a</sup> Voting stock.

<sup>b</sup> Subsidiaries of General Gas & Electric Corporation.

Almost immediately the company disposed of the preferred stock of Broad River Power Company and of Florida Public Service Company, and received in return 13,917 shares of Associated Gas and Electric Company \$5 preferred stock.<sup>365</sup>

#### a. Associated Gas and Electric Company Class A Stock

As has been indicated, the price of \$57 per share which Eastern Utilities Investing Corporation paid for the Associated Gas and Electric Company Class A stock was in no small measure the result of the trading operation in this stock by the Associated Gas and Electric Securities Company, Inc., which was financed in part with the proceeds of the sale of the Eastern Utilities debentures to the public.<sup>366</sup> As a consequence, Eastern Utilities Investing Corporation was caused to accept in discharge of Associated Gas and Electric Company's liability to the investment company in connection with the proceeds of the debenture sale a block of stock the price of which had been inflated through market operations the very debenture proceeds helped to finance. On April 3, 1929, the same day that these 77,500 shares of Associated Gas and Electric Company Class A stock were sold to Eastern Utilities Investing Corporation at \$57 per share,

<sup>364</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3772, Item 4.

<sup>365</sup> Id., Commission's Exhibit No. 3771, Part VII, Tables 32 and 33.

<sup>366</sup> See supra, pp. 688-9.



Associated Gas and Electric Securities Company, Inc., had first purchased this stock from its parent, the issuer, at a price of only \$35 per share.<sup>367</sup>

b. Investment in General Gas & Electric Corporation—An Accounting Aspect of This Investment

As of August 1927, the entire voting stock of Eastern Utilities Investing Corporation had been placed in Eastern Utilities Investing Trust,<sup>368</sup> subject to an option which Eastern Utilities Investing Trust granted to Associated Gas and Electric Company,<sup>369</sup> to repurchase the stock at the price it cost Eastern Utilities Investing Trust to acquire the stock. This voting stock of Eastern Utilities Investing Corporation remained in that trust until March 1932, and during that period the option was continued in effect.<sup>370</sup> Associated Gas and Electric Company, although it did not actually reacquire the control stock until March 1932, always had the power to obtain control at any time. Yet, by virtue of this option device whereby technical control was transferred although actual control was retained, the statement of Eastern Utilities Investing Corporation was not consolidated with Associated Gas and Electric Company, and a separate report on Eastern Utilities Investing Corporation was not furnished as part of Associated Gas and Electric Company's annual report. Eastern Utilities Investing Corporation held large blocks of Associated Gas and Electric Company securities in its portfolio. In addition, Eastern Utilities Investing Corporation, as will be described in greater detail hereafter, was caused to purchase \$26,000,000 of securities of General Gas & Electric Corporation, including one-half of the control stock of that corporation. By this transfer, Associated Gas and Electric Company avoided the inclusion of General Gas & Electric Corporation in its own consolidated statement and obviated the necessity of furnishing separate reports of General Gas & Electric Corporation as part of Associated Gas and Electric Company's annual reports.

At the end of 1929, Eastern Utilities Investing Corporation and General Gas & Electric Corporation held a total of \$133,312,844 of the debentures and stocks of Associated Gas and Electric Com-

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<sup>367</sup> *Op. cit. supra*, note 6, Commission's Exhibit No. 3811. Mr. Stix claims that the apparent profit to Associated Gas and Electric Securities Company, Inc., was accounted for as part of a payment to Associated Gas and Electric Company about the year-end. (*Id.*, at 25099-115.) In view of the subsidiary parent relation, this seems unimportant compared with the fact that Associated Gas and Electric Company was getting all it could for its Class A stock even from its controlled Eastern Utilities Investing Corporation. And even Mr. Stix's explanation admitted that \$6 out of every \$32 received by Associated Gas and Electric Securities Company, Inc., were kept by it as a "backlog for what was in reality additional capital for the purpose of absorbing the losses that looked as though it was going to have to absorb in the falling market." As to how the amount to be retained to absorb the security company's trading losses was determined, he said: "I think I just picked the amount, and it was just kind of horse sense." (*Id.*, at 25111-2.)

<sup>368</sup> See Appendix H, p. 798.

<sup>369</sup> See note 220, *supra*.

<sup>370</sup> *Op. cit. supra*, note 6, Commission's Exhibit No. 3772, Item 5.

pany.<sup>371</sup> Yet the fact that Associated Gas and Electric Company did not technically hold the voting control of these two companies<sup>372</sup> permitted Associated Gas and Electric Company to exclude both Eastern Utilities Investing Corporation and General Gas & Electric Corporation from the 1929 consolidated financial statements of Associated Gas and Electric Company. As a direct result of this failure to include these two companies in the consolidated statements of the top company, the capitalization and surplus of Associated Gas and Electric Company, indicated as \$500,688,742,<sup>373</sup> were inflated to the extent of the cross-holdings, namely \$133,312,844. The assets shown in the consolidated balance sheet of Associated Gas and Electric Company were similarly inflated by this procedure.

So, both the capitalization and assets were made to appear about \$130,000,000 greater than they would have been in an Associated Gas and Electric Company statement consolidating General Gas & Electric Corporation and Eastern Utilities Investing Corporation with the balance of the "System" controlled by Associated Gas and Electric Company. The prospective investors in Associated Gas and Electric Company securities may have been impressed by this seemingly larger company and by the lower ratio of debt to assets which the \$130,000,000 increase in both sides of the balance sheet indicated. More specifically, the consequence of these devices was that no disclosure was made of the fact that Associated Gas and Electric Com-

<sup>371</sup> Associated Gas and Electric Company securities held by Eastern Utilities Investing Corporation and by General Gas & Electric Corporation at December 31, 1929, and which would have been eliminated by a consolidation of these two companies with Associated Gas and Electric Company were as follows:

*Held by Eastern Utilities Investing Corporation, Dec. 31, 1929*

Description of security	Number of shares or par value of debentures	Cost value
Associated Gas & Electric Co. Class A stock.....	249, 754	\$11, 998, 877
Associated Gas & Electric Co. 6% Convertible Debentures, Series B of 1929.....	\$10, 150, 000	9, 642, 500

*Held by General Gas & Electric Corporation, Dec. 31, 1929 <sup>b</sup>*

Description of security	Number of shares or par value of debentures	Ledger value
Associated Gas & Electric Co., Common, Class A.....		\$65, 747, 651
Associated Gas & Electric Co. 6% Consolidated Debenture Bonds, 1929.....	\$31, 500, 000	29, 925, 000
5% Bonds, 1968.....	17, 557, 000	15, 998, 816
		133, 312, 844

<sup>a</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3795.

<sup>b</sup> Op. cit. supra, note 103, Part 70, pp. 884-6.

<sup>372</sup> Technical control was avoided by the use of these two devices (a) the transfer to Eastern Utilities Investing Trust of the block of stock which constituted the voting control of Eastern Utilities Investing Corporation, with an option back to Associated Gas and Electric Company to purchase this control block of stock, and (b) the splitting between Associated Gas and Electric Company and Eastern Utilities Investing Corporation of voting control of General Gas & Electric Corporation.

<sup>373</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3775.

pany, having capital and funded debt and surplus of \$500,688,742,<sup>374</sup> held through two subsidiaries its own securities carried by the controlled companies at a value of \$133,312,844. Furthermore, a complete consolidation would have prevented the inflation of the published income account of Associated Gas and Electric Company by that substantial part which was represented by payments of interest and dividends by Associated Gas and Electric Company, Eastern Utilities Investing Corporation, and General Gas & Electric Corporation to one another.

c. General Gas & Electric Corporation Class B Stock as an Indirect Investment in Associated Gas and Electric Company

As already mentioned above, Eastern Utilities Investing Corporation acquired as part of the list of securities received in lieu of the debenture proceeds about \$14,000,000 of Class B common (voting) stock and about \$12,000,000 of other securities of General Gas & Electric Corporation, or an aggregate of approximately \$26,000,000, equivalent to over 80% of the debenture proceeds.

Between the acquisition of control of General Gas & Electric Corporation in the early part of 1929 and the transfer of the blocks of securities of that corporation to Eastern Utilities Investing Corporation on April 3, 1929, Associated Gas and Electric Company had caused General Gas & Electric Corporation:

(a) To convey its four most important operating subsidiaries to Associated Gas and Electric Company in return for securities of Associated Gas and Electric Company. In consideration for this transfer of these major operating companies, General Gas & Electric Corporation received from Associated Gas and Electric Company its debentures, preferred and Class A stock.<sup>375</sup> As a result, Eastern Utilities Investing Corporation's investment in Class B and other stock of General Gas & Electric Corporation in April 1929 became indirectly an investment in Associated Gas and Electric Company, its own parent, and in April 1929 about 75% of the portfolio of General Gas & Electric Corporation consisted of securities of Associated Gas and Electric Company and its affiliated companies;<sup>376</sup> and

(b) To increase its capitalization by the issuance of all authorized but unissued securities permissible without amendment of the charter.<sup>377</sup>

By these transactions the portfolio of General Gas & Electric Corporation consisted predominantly of the securities of Associated Gas and Electric Company.<sup>378</sup> As a result, the investment of Eastern

<sup>374</sup> Ibid.

<sup>375</sup> Id., at 25071.

<sup>376</sup> Id., at 25071-2.

<sup>377</sup> Id., Commission's Exhibit No. 3820.

<sup>378</sup> Ibid. A similar removal of underlying operating properties from a newly acquired holding company had been successfully accomplished by those in control of Eastern Utilities Investing Corporation in 1926. See *supra*, pp. 641-62. *Transfer of Operating Companies and Effect Thereof*.

Mr. Stix testified (*op. cit.* *supra*, note 6, at 25071): "Well, we did what we thought was removing temptation by transferring the ownership of four major operating companies from General Gas to either the Associated or subsidiaries of the Associated."

Mr. Stix referred to Metropolitan Edison Company, Northern Pennsylvania Power Company, New Jersey Power & Light Company and Binghamton Light, Heat & Power Company. (Id., Commission's Exhibits Nos. 3820-1.)

Utilities Investing Corporation in General Gas & Electric Corporation was not an investment in a separate utility holding company but an investment indirectly in additional securities of Associated Gas and Electric Company.<sup>379</sup> And since, as indicated above, the Broad River Power Company and Florida Public Service Company preferred stocks were almost immediately replaced in Eastern Utilities Investing Corporation's portfolio by preferred of Associated Gas and Electric Company, Eastern Utilities Investing Corporation, in lieu of receiving the cash proceeds of its debenture issue, in substance acquired a \$32,800,000 investment which was primarily an interest (direct and indirect) in the securities of Associated Gas and Electric Company.

#### d. Investment Character of General Gas & Electric Corporation Class B Stock

In discussing whether it would have been advisable for Associated Gas and Electric Company to issue its own debentures in order to raise money to pay for the acquisition of control of General Gas & Electric Corporation, Mr. Stix testified as follows:<sup>380</sup>

A. I would say that the net cost of the money to Associated was probably somewhere between 4¾ and 5%.

Q. And had you raised that money through a debenture issue, it would have made your acquisition of General Gas unprofitable?

A. I think that is right, and perhaps impossible.

The cash raised through the issuance of debentures of Eastern Utilities Investing Corporation cost Eastern Utilities Investing Corporation over 5% annually.<sup>381</sup> The Class B stock of General Gas & Electric Corporation in which Eastern Utilities Investing Corporation invested over \$14,000,000 was then paying between \$2 and \$2.75 a year in cash dividends.<sup>382</sup>

The explanation which Mr. Stix offered for the investment of Eastern Utilities Investing Corporation's funds in General Gas & Electric Corporation Class B stock was, in effect, that dividends on the General Gas & Electric Corporation Class B stock were payable, at the option of the holder, in Class A stock of that company, and that on the basis of the then market value of such Class A stock the dividends on the aforementioned Class B stock would be 10%. His conclusion was that Eastern Utilities Investing Corporation, by accepting these stock dividends, could obtain a satisfactory return.<sup>383</sup>

Apparently, however, Eastern Utilities Investing Corporation did not sell any of the stock dividends it received from its investment in General Gas & Electric Corporation Class B stock until 1934, when

<sup>379</sup> Id., at 25071.

<sup>380</sup> Op. cit. supra, note 46, pp. 1115-7.

<sup>381</sup> Id., at 1149, and see supra, p. 684.

<sup>382</sup> Op. cit. supra, note 46, at 1146-7.

<sup>383</sup> Id., at 1152. Several months after Eastern Utilities Investing Corporation had made a substantial profit by selling General Gas & Electric Corporation Class A stock to an affiliated company, the profit was eliminated upon an advice from the Ithaca, New York office of the Associated System to the effect that the figures be adjusted so that the sale should be at cost to Eastern Utilities Investing Corporation rather than at market. The explanation given for the surrender of this profit by the investment company was that it was a practice in the Associated System for securities to be transferred among "System" companies at cost and that some officer or director of Eastern Utilities Investing Corporation had probably noticed the profit in violation of this practice and had caused the reversing advice to be sent.

it disposed of all of its holdings in General Gas & Electric Corporation stock, then consisting of 1,134,178 shares of Class A stock, together with \$3,123,000 principal amount of Associated Gas and Electric Company 5% Convertible Obligations, Series A, in order to reacquire \$6,917,000 principal amount of its own debentures.<sup>384</sup>

e. Selection of the Investments Acquired in Lieu of Proceeds of the Debenture Issue

The list of securities which was placed in Eastern Utilities Investing Corporation's portfolio in lieu of cash proceeds of the sale of the debentures had been made up by employees of Mr. Hopson's service companies, Mr. Daly, Mr. Third, or Mr. Stix.<sup>385</sup> In spite of the size of the transaction, Mr. Stix stated that he was unable to recall the part he played in making up the list. He testified, however:<sup>386</sup>

Actually, I don't think we paid much attention to it; at least we did not give it any serious import because one of the purposes of the financing was to help raise money for the Associated Gas and Electric Company.

However, according to Mr. Stix, Associated Gas and Electric Company "felt a moral responsibility to the Eastern Utilities Investing Corporation in view of the intended use of the proceeds."<sup>387</sup>

Out of a total of approximately \$32,800,000 in securities placed in the portfolio of Eastern Utilities Investing Corporation in lieu of the cash proceeds from its debentures, approximately \$26,000,000 constituted General Gas & Electric Corporation securities. Mr. Stix gave the following explanation for this large holding:<sup>388</sup>

In the first place, there was a very substantial amount of General Gas & Electric Corporation securities in the portfolio of the Associated Gas and Electric Company which it preferred not to sell, but which had certain, or represented certain credit resources. That would be one way of being able to realize on those credit resources. In the second place, the proceeds from the sale of the Eastern Utilities Investing Corporation debentures went to a substantial extent to continue the purpose of General Gas & Electric Corporation. So they seemed to naturally flow together.

Mr. Hopson gave his entire approval to the afore-mentioned list of securities which went into Eastern Utilities Investing Corporation, including this large block of General Gas & Electric Corporation securities, either directing that such a list of securities be made up, or approving the list after one of his men had prepared it as "one of the things that had to be done in connection with this financing and in an endeavor to make ourselves useful."<sup>389</sup>

<sup>384</sup> Op. cit. supra, note 46, at 1155; and op. cit. supra, note 6, Commission's Exhibit No. 3771, Part VII, Table 33.

<sup>385</sup> Op. cit. supra, note 6, at 25019.

<sup>386</sup> Ibid.

<sup>387</sup> Id., at 25020.

<sup>388</sup> Id., at 25041.

<sup>389</sup> Ibid. Mr. Stix testified (id., at 25040):

Q. In 1929 he [Mr. Hopson] still had that full responsibility of direction, had he not?

A. Yes.

Q. So having that in mind, would you not say that the list of securities to go into Eastern Utilities Investing Corporation just after the debenture issue received his entire approval before those securities were put into Eastern Utilities Investing Corporation?

A. Yes; I would say so.

With rare exceptions, the minutes of the board of directors of Eastern Utilities Investing Corporation do not disclose that the board specifically authorized acquisitions or dispositions of securities. Mr. Bowman, a partner of Haskins & Sells, testified regarding the lack of authorization by the board of the disposition or acquisition of significant quantities of securities:<sup>390</sup>

Q. What did you find wrong with the company's procedure in that regard?

A. We felt there should be formal action by the board of directors with respect to the security transaction.

Q. With respect to each transaction?

A. Well, at least those of any importance.

Mr. Stix told Haskins & Sells that this practice of not securing board authorization for investments was justified because, since Eastern Utilities Investing Corporation was an investment company, they were all transactions "in the regular course of business."<sup>391</sup> However, the effect of this practice was an abdication by the board as a board of its own power and duty to direct the management of the company. And accordingly, although a transaction might be discussed with some member of the board in addition to Mr. Hopson,<sup>392</sup> decisions as to the investments to be made were left to the management, Messrs. Hopson, Daly, and Stix, even though of major importance.

The investment of the debenture proceeds was no exception to this practice, although it almost doubled the size of the company's portfolio. The minutes do not show that the board of directors or the executive committee took any action with respect to this investment. Mr. Stuart, of Halsey, Stuart & Co., Inc., who became a member of the board of directors of Eastern Utilities Investing Corporation at that time, did not recall ever having known in what securities the proceeds were invested. Mr. Hopson and Mr. Burroughs, of course, knew, because they arranged the transaction. Mr. Hopson either directed the preparation of the list or approved it.<sup>393</sup>

The board of directors, in addition to Mr. Hopson and Mr. Mange and Mr. Burroughs, consisted of Garrett A. Brownback, who was formerly, and has been since, counsel for the "System," although at the time he was a partner of Field, Gloré & Company; John M. Daly, vice president of Associated Gas and Electric Company and an assistant to Mr. Hopson; Warren Partridge,<sup>394</sup> vice president of New England Gas and Electric Association, which was a subsidiary of Associated Gas & Electric Properties, jointly controlled by Mr. Hopson and Mr. Mange; Daniel Starch, brother-in-law of Mr. Hopson and the head of the advertising firm of Daniel Starch and Staff, which handled the "System's" advertising; and Charles B. Stuart, of Halsey, Stuart & Company, Inc., which had just been accepted as associate bankers for the "System."<sup>395</sup> Under Mr. Hopson as president of Eastern Utilities Investing Corporation were Mr. Daly, Mr. Stix, and three employees of Hopson service companies.<sup>396</sup>

<sup>390</sup> Id., at 24210.

<sup>391</sup> Id., at 24214-5.

<sup>392</sup> Op. cit. supra, note 46, pp. 1129-37.

<sup>393</sup> Op. cit. supra, note 6, at 27344-6; 25019-21; 25039-41.

<sup>394</sup> This is the father, not the son, who is still with the "System." (Id., at 23468.)

<sup>395</sup> Id., Commission's Exhibit No. 3771, Part I.

<sup>396</sup> Ibid.

After the close of a calendar year of operations Haskins & Sells would point out that transactions had not been authorized by the board, and the board would then pass a general resolution ratifying and confirming all action of the officers taken during the year, including all acquisitions and dispositions of securities. It is accordingly clear that Mr. Hopson, either directly or through instructions to Mr. Daly and Mr. Stix, decided which investments Eastern Utilities Investing Corporation should hold, dispose of, or acquire, and that long after the transactions occurred the board would go through the formality of ratifying his decisions.

Mr. Burroughs, with reference to the use of the debenture proceeds, testified as follows:<sup>397</sup>

A. \* \* \* I think we did know it would be invested in the Associated System securities, but I don't think we decided to put it into General Gas & Electric Corporation stock at the time of the offering.

Q. At the date of the circular, you, as an individual, knew it was planned to invest practically all the proceeds in securities of the Associated System?

A. That is as I recall it. It is a little hard to remember back ten years and say definitely what day you made up your mind to do a certain thing, and I can't do that; but I do know it was the general idea of the Board to invest the proceeds of this financing in securities of the Associated System. I don't remember on what day or how we decided to buy a particular security. I couldn't do that.

At that time Mr. Burroughs was representing at least three different conflicting interests. He was not only a partner of the bankers, Harris, Forbes & Company (who had been financial advisers of the "System" since 1926) but a director of Associated Gas and Electric Company<sup>398</sup> and of Eastern Utilities Investing Corporation.<sup>399</sup> Mr. Burroughs testified:<sup>400</sup>

Q. In this case you were in a triple capacity of being a director of Harris, Forbes, Associated Gas and Eastern Utilities Investing?

A. I was probably in a sextuple capacity, being director of some other companies, too.

His directorship of Eastern Utilities Investing Corporation resulted from its being controlled by the Associated Gas and Electric System for which he was financial consultant. And admittedly, Eastern Utilities Investing Corporation was just one of two or three hundred companies of which Mr. Burroughs was a director,<sup>401</sup> whereas Associated Gas and Electric Company controlled most of the "System." Mr. Stix, comptroller of Associated Gas and Electric Company and now a vice president, admitted that Eastern Utilities Investing Corporation was conceived for the purpose of aiding in the financing of Associated Gas and Electric Company.<sup>402</sup>

<sup>397</sup> Id., at 23546.

<sup>398</sup> Id., at 23293, 23445-6, and Commission's Exhibit No. 3775.

<sup>399</sup> Id., at 23461, 23466, and Commission's Exhibit No. 3832.

<sup>400</sup> Id., at 23466.

<sup>401</sup> Id., at 23462. Mr. Burroughs testified (ibid.):

Q. How many years were you a director?

A. I don't know. I don't know the date I was elected or resigned. The last ten or fifteen years I have been a director in at least two or three hundred corporations, domestic and foreign. That is what minutes are for.

Q. And Eastern Utilities Investing Corporation was just one of two or three hundred companies of which you were a director?

A. Well, haven't I just said that?

<sup>402</sup> See supra, pp. 680-2.



## 9. SECONDARY DISTRIBUTION OF EASTERN UTILITIES INVESTING CORPORATION DEBENTURES

Although the entire Eastern Utilities Investing Corporation debenture issue of \$35,000,000 was sold, a considerable amount of these debentures came back into the market.<sup>403</sup> The syndicate bought such debentures and resold them either in the market or through the sales organizations of the underwriters.<sup>404</sup> H. C. Hopson on behalf of Associated Gas and Electric Company agreed with the underwriters to "repurchase" from them up to \$3,000,000 principal amount of Eastern Utilities Investing Corporation debentures.<sup>405</sup> Subsequently, this agreement was extended for one month on the condition that the principal amount which Associated Gas and Electric Company would be obligated to "repurchase" would be reduced from \$3,000,000 to \$2,000,000.<sup>406</sup> The representatives of the bankers were unable to recall this

<sup>403</sup> Id., at 23491. A tabulation entitled "Harris, Forbes & Company—Analysis of Purchases and Sales in Connection with the 'Trading Account' Formed in Connection with the Original Issue of \$35,000,000—Eastern Utilities Investing Corporation 5% Debentures Due 1954" shows that during the period March through August 1929, Harris, Forbes & Company on behalf of the syndicate made the following purchases and sales in a trading account with a resulting profit of \$102,893.75 (supplementary information supplied the Commission by Amerex Holding Corporation, which is in possession of certain records of Harris, Forbes & Company, through George D. Woods, formerly assistant to Mr. Burroughs):

	<i>Bonds purchased (par value)</i>	<i>Bonds sold (par value)</i>
1929:		
March-----	\$290, 000	\$3, 835, 000
April-----	1, 728, 000	2, 000
May-----	773, 000	253, 000
June-----	1, 058, 000	1, 807, 000
July-----	3, 864, 000	2, 399, 000
August-----	723, 000	140, 000
	<hr/> 8, 436, 000	<hr/> 8, 436, 000

A tabulation entitled "Statement of the Amount of Eastern Utilities Investing Corporation Debenture 5s of 3/15/54, acquired by Halsey, Stuart & Co., Inc. after Original Offer, by Months" shows that Halsey, Stuart & Co., Inc. acquired the following principal amount of debentures in the following years:

1929-----	\$2, 201, 000
1930-----	571, 000
1931-----	56, 000
1932-----	138, 000
March and April 1933-----	31, 000
<b>Total-----</b>	<hr/> 2, 997, 000

It also shows that thereafter the firm reacquired no Eastern Utilities Investing Corporation debentures. (Derived from supplementary information supplied the Commission by Halsey, Stuart & Co., Inc.)

<sup>404</sup> Ibid., and op. cit. supra, note 6, at 23492.

<sup>405</sup> Id., at 27228, Commission's Exhibit No. 3842, Item 18. Wire dated July 1, 1929, from the New York office of Harris, Forbes & Company to Harris Trust & Savings Bank offered to take back debentures at 92½ from syndicate participants and explained that "\* \* \* Syndicate shortage is two million and in addition Hopson has agreed take three million more from proceeds General Gas & Electric preferred. Berta [in charge of trading] hopes take care of more than five hundred thousand of our bonds."

<sup>406</sup> Id., Commission's Exhibit No. 3842, Item 20 (identified at 27230) is a letter dated July 24, 1929, to The Harris Forbes Corporation, signed by H. C. Hopson as vice president of Associated Gas and Electric Company, which reads: "Referring to our letter to you dated June 11, 1929, with respect to the repurchase by us on or before August 1, 1929, at your request, of 5% Gold Debentures due March 15, 1954, of Eastern Utilities Investing Corporation up to a principal amount of \$3,000,000, this is to confirm our oral understanding that the period within which you may make such request and within which we will repurchase such Debentures is extended to and including September 1, 1929, and that the principal amount of such Debentures which we are obligated to take up at your request is limited to a maximum of \$2,000,000. Except as herein expressly modified, our said agreement of June 11, 1929, is hereby confirmed \* \* \*."



agreement at the public examination and in the time available it was not ascertained to what extent, if any, debentures had been purchased pursuant to this agreement. However, the underwriters did maintain a market for the debentures <sup>407</sup> and it is apparent from the existence of this agreement that the underwriters desired support for their maintenance of a market during the secondary distribution. It is also apparent that the management of Associated Gas and Electric Company was willing to commit that company to "repurchase" \$3,000,000 principal amount of Eastern Utilities Investing Corporation debentures in order to further such market support.

During 1930 Harris, Forbes & Company made purchases and sales of Eastern Utilities Investing Corporation debentures in what they called a "sole account," <sup>408</sup> and it apparently was this account to which reference was made in an inter-office memorandum dated August 12, 1930, reading:

Some weeks ago when Eastern Utilities debenture 5s were selling even more out of line with the market than they are today, we started a trading account to bring the price back to somewhere near a normal level. \* \* \* up to the present time this account has been very successful. This last week sales have dried up \* \* \*. In order to keep the market where it is and improve it slightly, it will be necessary for us to buy from ten to twenty bonds per day, and, naturally, we will have to sell an equal or greater amount. Having done 90% of the job, we hesitate to even think of letting this market slide back, and are, therefore, going to ask each member of the department to make a special effort to place these bonds. \* \* \* <sup>409</sup>

However, by May 1931 Mr. Hopson had evidently "tired" of supporting the market for the Eastern Utilities Investing Corporation debentures, and determined upon a program of exchange offers by which securities of other companies in the Associated System were to be offered to investors in exchange for the debentures of Eastern Utilities Investing Corporation. <sup>410</sup> A message sent over the private wire of Halsey, Stuart & Co., Inc., from Mr. Shrader of its Chicago office to Mr. Niver, of its New York office, on May 13, 1931, reads: <sup>411</sup>

WHAT IS HOPSON REAL PURPOSE IN OFFERING PROPOSED EXCHANGE FOR EASTERN UTILITIES 5s \* \* \*

<sup>407</sup> Op. cit. supra, note 6, at 27217, 27229.

<sup>408</sup> A tabulation entitled "Purchases and Sales of Eastern Utilities Investing Corporation, 5% Debentures due March 15, 1954, taken from the Security Ledgers of 'Sole Account' of Harris, Forbes & Co., N. Y., from May 31, 1930, to Dec. 31, 1932," shows that during June 1930, \$170,000 principal amount was purchased and none sold; that during July 1930, \$335,000 principal amount was purchased and \$337,000 principal amount sold at a small profit. The tabulation also shows that by March 1931, \$1,228,000 principal amount had been purchased and sold at a loss of \$56,707. It further shows that by the end of 1932 the total amount purchased and sold in the account was \$1,494,000 principal amount at an aggregate loss of \$53,652. The table bears the following notation: "These transactions represent securities purchased and sold from and to Dealers, Brokers, Individuals, and Corporations, and is known as 'Sole Account.' According to the records of Harris, Forbes & Company, there was no 'Trading Account' formed from August 12, 1930, to December 31, 1932." (Derived from supplementary information supplied the Commission by Amerex Holding Corporation as indicated supra, note 403.)

<sup>409</sup> Op. cit. supra, note 6, at 27220-1 and Commission's Exhibit No. 3842, Item 28.

<sup>410</sup> Id., Commission's Exhibit No. 3843, Item 15.

<sup>411</sup> Ibid. See also Items 26 and 27.

On this message is written Mr. Niver's answer, as follows:

Just another idea of Hop's to improve market for Eastern Utilities 5's, says he is tired trying to keep market in line by purchasing bonds and he thinks exchanges will take off market substantial amount of bonds \* \* \*

## G. Operations of Eastern Utilities Investing Corporation from April 1929 to June 1931

### 1. PORTFOLIO OF EASTERN UTILITIES INVESTING CORPORATION IN APRIL 1929

As has been indicated, the securities which Eastern Utilities Investing Corporation received on April 3, 1929, consisted chiefly of securities of General Gas & Electric Corporation.<sup>412</sup> The complete list of portfolio securities of Eastern Utilities Investing Corporation, after the debenture issue, was as follows:<sup>413</sup>

Issuer	Class	Carrying value	Percent
Associated Gas & Electric Co. ....	Class A. ....	\$4,417,500	5.5
Do. ....	\$5 pfd. ....	7,349,920	9.1
Do. ....	Conv. Obl. ....	5,194,573	6.4
General Gas & Electric Corporation. ....	Class B. ....	14,250,000	17.6
Do. ....	\$8 pfd. A. ....	4,720,657	5.8
Do. ....	\$7 pfd. B. ....	3,366,120	4.2
Do. ....	Class A. ....	2,160,000	2.7
Do. ....	\$7 pfd. A. ....	1,946,460	2.4
Gas & Electric Associates. ....	8% pfd. ....	8,400,000	10.4
Public Utility Investing Corporation. ....	6% pfd. ....	1,500,000	1.9
Utility Management Corporation. ....	7% pfd. ....	5,000,000	6.2
Consumers Construction Co. ....	7% pfd. ....	5,000,000	6.2
The J. G. White Management Corporation. ....	7% pfd. ....	100,000	0.1
Other affiliated companies. ....		1,371,260	1.7
Total affiliated companies. ....		64,776,490	80.2
Nonaffiliated companies. ....		15,996,110	19.8
Total portfolio. ....		80,772,600	100.0

Of the total investments, 21% was in securities of Associated Gas and Electric Company and 59% in that company's subsidiaries and affiliates, with 33% concentrated in General Gas & Electric Corporation. To a substantial extent, Eastern Utilities Investing Corporation's investment in General Gas & Electric Corporation in April 1929 was indirectly an investment in Associated Gas and Electric Company, and by then about 75% of the portfolio of General Gas & Electric Corporation consisted of securities of Associated Gas and Electric Company and its affiliated companies.<sup>414</sup>

Despite the avowed policy of the company which was stressed in the sale of its debentures, the portfolio of Eastern Utilities Investing Corporation showed a lack of diversification immediately after the

<sup>412</sup> See supra, pp. 692-4, *Investment in General Gas & Electric Corporation*.

<sup>413</sup> Op. cit. supra, note 6, Commission's Exhibits No. 3772, Item 4 and No. 3805.

<sup>414</sup> Id., at 25071-2.

issuance of \$35,000,000 principal amount of debentures. Approximately 80% of the total portfolio cost was concentrated in Associated Gas and Electric Company, its subsidiaries, and affiliates. Approximately 12% of the total portfolio cost was invested in one other company, Utilities Power & Light Corporation. Of the remaining 8%, over 6% was invested in 19 utility companies operating in New England, of which the "System" was attempting to buy control.<sup>415</sup> The balance of the proceeds, or less than 2%, was invested in other utility companies.<sup>416</sup>

## 2. MANAGEMENT OF EASTERN UTILITIES INVESTING CORPORATION

Subsequent to the sale of the debenture issue no change in the modus operandi of Eastern Utilities Investing Corporation took place, for it continued to be managed entirely by representatives of Mr. Hopson acting through Associated Gas and Electric Company and Mr. Hopson's service companies. Eastern Utilities Investing Corporation still had no office of its own and still maintained the same address as that of the Hopson service companies, at 61 Broadway, New York City.<sup>417</sup> Its board of directors remained, as before, composed of officers of Associated Gas and Electric Company or lawyers or bankers rendering service to that company and the "System."<sup>418</sup> Upon the debenture financing, Mr. Stuart of Halsey, Stuart & Co., Inc., joined the board, of which Mr. Burroughs had been a member since his banking firm of Harris, Forbes & Company had been retained as financial advisers to the "System" in 1926. Mr. Brownback was attorney for the Associated Gas & Electric System.<sup>419</sup> The officers of Eastern Utilities Investing Corporation were under Mr. Hopson's control.

The board of directors of Eastern Utilities Investing Corporation did not make it a practice to pass upon investments before they were made, but instead customarily ratified the transactions, if at all, long after they had been effected.<sup>420</sup> Mr. Stuart, who went on the board presumably to represent his firm in performing its obligations to its clients, stated that he did not know which securities were bought and sold and did not know why he was on the board.<sup>421</sup> Mr. Stuart testified:<sup>422</sup>

<sup>415</sup> These companies were subsidiaries of New England Power Association, a nonaffiliate of Associated Gas and Electric Company.

<sup>416</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3805:

(a) 226,201 shares of Class B common stock of Utilities Power & Light Corporation carried at-----	\$9, 731, 442
(b) Securities of 19 utility companies operating in New England and now subsidiaries of New England Power Association (a nonaffiliate) carried at-----	5, 202, 789
(c) Securities of 4 utility companies operating in New England and now subsidiaries of New England Gas and Electric Association (an affiliate) carried at-----	325, 180

<sup>417</sup> See supra, pp. 632-5, *Eastern Utilities Investing Corporation Controlled by Associated Gas and Electric Company*.

<sup>418</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3771, Part I.

<sup>419</sup> Id., at 23502-3.

<sup>420</sup> Id., at 24210-1 and supra, p. 649.

<sup>421</sup> Id., at 27370-1.

<sup>422</sup> Ibid.

Q. Well, did you attend directors' meetings regularly when you were a director?

A. No; I did not.

Q. Were you a director continuously from the time you went on the board, April 1, 1929, until the date that you resigned, December 31, 1932?

A. Yes.

Q. Now, what was the purpose of your being on the board of Eastern Utilities Investing Corporation as a representative of Halsey, Stuart & Company?

A. Well; I really don't know. I can't answer your question.

Q. As a director of Eastern Utilities Investing Corporation, what were you able to accomplish along the lines of protecting the public holder of the Eastern Utilities Investing Corporation debentures?

A. I suppose the theory of my being a director was to attend all the meetings and report everything that happened.

Q. But you didn't do that?

A. No; I only attended very few meetings, but I did see a lot of the different directors and had some idea of what the company was doing.

Q. Did you ever oppose any of the switches of the securities which the company carried out?

A. I don't recall that I ever did.

Q. Now, since the indenture didn't place a restriction on portfolio switches, the bankers' having a representative on the board was about the only way that they could prevent any unwise switches in the securities. Isn't that so?

A. No; that isn't the case at all. As a matter of fact, I only had one vote, I couldn't have prevented anything. I might have protested, but that is as far as I could have gone.

Q. So your being on the board really didn't add any protection to the public investor, did it?

A. No; I don't think so.

A. And yet in theory, that was the primary reason for your being on the board, isn't it?

A. Apparently that is it. I don't know yet why I was put on, as I told you before.

Mr. Stix and Mr. Daly, immediate assistants to Mr. Hopson, seem to have been primarily charged with handling the corporation's investments. They would switch securities pursuant to directions of Mr. Hopson, or would prepare lists of investments which they thought would carry out his policies and thereafter submit them for his approval; in some cases they may have made some investments without consulting Mr. Hopson because of their knowledge that such transactions would be in line with his wishes.<sup>423</sup>

Mr. Hopson and Mr. Mange had complete control of Eastern Utilities Investing Corporation through the indirect ownership of all of its voting stock by Associated Gas & Electric Properties.<sup>424</sup> Until July 1927, this control stock was indirectly owned by Associated Gas & Electric Properties through Associated Gas and Electric Company. From then until 1932, the control stock was owned through another subsidiary of Associated Gas & Electric Properties, while Associated Gas and Electric Company retained an option to reacquire this stock

<sup>423</sup> Id., at 25019-21, 25039-41. See also id., at 24681, 24687-8, 23375-6, and 23389.

<sup>424</sup> See supra, pp. 632-5, and Appendix H, p. 798.

at cost.<sup>425</sup> From the moment in 1925 when control was bought by Associated Gas and Electric Company until Eastern Utilities Investing Corporation went into 77B bankruptcy proceedings in October 1936, Eastern Utilities Investing Corporation never entered into a transaction involving the purchase, sale, or exchange of portfolio securities except with some Associated Gas & Electric System company.<sup>426</sup> The individuals controlling every portfolio transaction of Eastern Utilities Investing Corporation, whether of purchase, sale, or exchange, were the same on both sides of the transaction. They represented the purchaser and the seller in the transactions which involved the use of the public's funds. Mr. Stix, who executed Mr. Hopson's orders and who had most to do with these transactions, testified that he saw no adverse interest between a buyer and a seller,<sup>427</sup> and therefore no conflict of interest in representing both sides; that the price at which Eastern Utilities Investing Corporation acquired or disposed of securities "didn't have a great deal of significance" and that he could assign any prices for the securities that he wanted to, provided they were "reasonable."<sup>428</sup> He did not indicate that the reasonableness of these prices was subject to review.

The shifts in the portfolio securities of Eastern Utilities Investing Corporation were apparently made with little regard for the interests of that company, and when the company was in financial difficulties as a result of these shifts, apparently no effort was made to improve its condition.<sup>429</sup> Mr. Stix testified:<sup>430</sup>

Q. So that at that time [1929], Eastern Utilities Investing Corporation's equity in relation to its debentures was better than Associated Gas and Electric Company's equity with relation to its debentures?

A. Yes, sir.

Q. And now Eastern Utilities Investing Corporation is now in 77-B proceedings, and Associated Gas and Electric Company is not, is that right?

A. That is right.

Q. And you still say that the price at which you put securities into Eastern Utilities Investing Corporation didn't matter?

A. Well, it would appear that subsequent events bear that out, because in spite of the large equity that Eastern Utilities Investing Corporation had, and plus or less what we put into it, it still went broke, and Associated Gas and Electric Company didn't.

Q. Well, while Eastern Utilities Investing Corporation was going along very well, you put securities in and took securities out quite freely, at will, did you not?

A. Yes; to a large extent.

Q. Now, when Eastern Utilities Investing Corporation got in trouble, why didn't you put securities in that would keep its equity ratio high enough so as to keep it out of trouble?

<sup>425</sup> See note 220, *supra*.

<sup>426</sup> *Op. cit. supra*, note 6, at 23563.

<sup>427</sup> *Id.*, at 23332.

<sup>428</sup> *Id.*, at 25119-20.

<sup>429</sup> *Id.*, at 25122.

<sup>430</sup> *Id.*, at 25121-4, and Commission's Exhibit No. 3783. See *infra*, pp. 772-5, *Institution of 77 B Proceedings in Bankruptcy*. See also *op. cit. supra*, note 6, Commission Exhibit No. 3824. Eastern Utilities Investing Corporation was placed in reorganization proceedings under Section 77 B of the Bankruptcy Act at the direction of Associated Gas and Electric Company.

A. Well, because it was much easier to bail out the security holders of Eastern Utilities Investing Corporation rather than to bail out Eastern Utilities Investing Corporation itself.

Q. So that you decided when and how the security holders of the Eastern Utilities Investing Corporation should be bailed out?

A. Well, I don't know as we decided when and how; we decided what we thought was in the best interests of all of the Associated security holders as a whole, and that would be to place the Eastern Utilities Investing Corporation debenture holders in substantially the same position as they would have been in if in the first place they had bought Associated securities.

Q. In the first place, you sold them the securities of the Eastern Utilities Investing Corporation, didn't you?

A. Yes, sir.

Q. And then you let Eastern Utilities Investing Corporation get into trouble, isn't that right?

A. We didn't let it get into trouble; the market drove it into trouble.

Q. You didn't prevent it?

A. We couldn't prevent it.

Q. And you would put the securities in, whose market value did get it into trouble; is that right?

A. Yes.

Q. And then to get Eastern Utilities Investing Corporation securities holders out of trouble, you forced them to buy securities or rather to take in exchange, securities of Associated Gas and Electric Company?

A. We didn't force them to.

Q. The only way that they could get bailed out from their Eastern Utilities Investing Corporation investment, if you want to call it that, would be to take in exchange securities of the Associated Gas and Electric Company?

A. No; they could sell them; there was a market for them.

Q. And what was the market price?

A. I don't know; comparatively low.

Q. About \$1.00 or \$2.00?

A. No; I don't think that they ever got as low as that.

Q. \$8.00 or \$10.00?

A. I wouldn't be surprised if that was right, which is about where the Associated debentures went to, I would say.

### 3. PORTFOLIO CHANGES FROM APRIL 1929 TO JUNE 1931

With successive changes effected in the portfolio of Eastern Utilities Investing Corporation, the portfolio became even less diversified. In April 1929, the same month in which the list of securities was received in lieu of its debenture proceeds, the corporation was caused to sell to other "System" companies<sup>431</sup> some of its investments in nonaffiliated companies carried at \$2,706,500.<sup>432</sup> The concentration of portfolio investments thus became even more intensified, despite the announced portfolio policy of diversification. Subsequent sales of this type of security eliminated practically all the remaining securities of nonaffiliated companies by October 1931.<sup>433</sup>

<sup>431</sup> Associated Gas and Electric Company, The General Finance Corporation and Associated Corporation. (Id., Commission's Exhibit No. 3771, Part VII, Table 33.)

<sup>432</sup> Id., Commission's Exhibit No. 3771, Part, VII, Table 33.

<sup>433</sup> See *infra*, pp. 720-3.

## a. Associated Gas and Electric Company Class A Stock

In April 1929 Eastern Utilities Investing Corporation purchased and sold large blocks of Associated Gas and Electric Company Class A stock. The list of securities delivered to Eastern Utilities Investing Corporation in lieu of its debenture proceeds included 77,500 shares of that Class A stock at a price of \$57 per share or a total cost of \$4,417,500.<sup>434</sup> In addition, the Corporation purchased 121,500 shares of the Class A stock at the same price during the same month from Associated Gas and Electric Securities Company, Inc., an Associated Gas and Electric Company subsidiary,<sup>435</sup> making the total purchases 199,000 at \$57 per share or \$11,343,000. The market price of the Class A stock at the time of the sale was \$55<sup>7</sup>/<sub>8</sub> to \$60<sup>1</sup>/<sub>8</sub>.<sup>436</sup> During the same month, with the same market prices prevailing, Eastern Utilities Investing Corporation was caused to sell 77,000 shares of the same stock at \$52.89 per share and 20,000 shares at \$55.12 per share to The Associated Corporation, also a subsidiary of Associated Gas and Electric Company.<sup>437</sup> The weighted average sales price was, therefore, \$53.35 per share and the loss on these 97,000 shares sold averaged \$3.65 per share or approximately \$355,000 within less than a month after purchase.

Associated Gas and Electric Securities Company, Inc., had paid in only \$35 per share to Associated Gas and Electric Company for these same shares which it sold to Eastern Utilities Investing Corporation.<sup>438</sup> Furthermore, at the end of April 1929, Eastern Utilities Investing Corporation still held 102,000 shares of the Class A stock<sup>439</sup> costing \$57 per share, a price which apparently was the result primarily of the "System's" market operations in that stock.<sup>440</sup> During the year 1929, over \$2,500,000 shares of this Class A stock were purchased by the "System" on the New York Curb Exchange<sup>441</sup> whereas most of the sales were made off the exchange.<sup>442</sup> During 1929, 7,100,000 shares were distributed off the market by direct sales, as dividends and in exchange for securities of subsidiaries,<sup>443</sup> and consequently did not counterbalance the effect of this extensive buying on the market price of the stock. During the five months ending April 30, 1929, Associated Gas and

<sup>434</sup> See *supra*, pp. 691-2.

<sup>435</sup> *Op. cit. supra*, note 6, Commission's Exhibit No. 3771, Part VII, Table 32.

<sup>436</sup> *Ibid.* Mr. Stix testified (*id.*, at 24742-3):

Q. Did not Associated Gas and Electric Securities Company sell 199,000 shares of Associated Gas and Electric Company Class A stock to Eastern Utilities Investing Corporation?

A. It did.

Q. When?

A. In April 1929.

Q. At what price?

A. Fifty-seven.

Q. What was the total cost?

A. \$11,343,000.

Q. You have testified, have you not, that this price of \$57 a share represented the market price of Class A stock at the time of acquisition?

A. I do not recall that I did, but I believe that it was about the market at that time.

Q. That was the basis on which Eastern Utilities Investing Corporation acquired it, was it not?

A. Yes.

<sup>437</sup> *Id.*, Commission's Exhibit No. 3771, Part VII, Table 33.

<sup>438</sup> *Id.*, at 25109-11.

<sup>439</sup> *Id.*, Commission's Exhibit No. 3771, Part VII, Tables 32 and 33.

<sup>440</sup> See *supra*, pp. 689-91.

<sup>441</sup> *Op. cit. supra*, note 6, at 24740.

<sup>442</sup> *Id.*, at 24739-40.

<sup>443</sup> *Id.*, at 24735-6.

Electric Securities Company, Inc., purchased 761,500 shares of the New York Curb Exchange or 84.2% of the 903,800 shares traded in on that exchange; and the market price rose from a low of \$47 in December 1928, to a high of over \$60 in April 1929.<sup>444</sup>

As has been indicated, part of the cash proceeds of the sale of the Eastern Utilities Investing Corporation debentures which were transferred to Associated Gas and Electric Company were used by Associated Gas and Electric Securities Company, Inc., to conduct the market operation in the Class A stock of Associated Gas and Electric Company which was subsequently sold to Eastern Utilities Investing Corporation.<sup>445</sup> As a consequence, part of the proceeds of the debenture issue was used to finance the market operations which seemingly inflated the price of the stock which the Eastern Utilities Investing Corporation purchased at these higher prices.

Mr. Stix, when examined on the use of these proceeds to inflate the price of stock, testified:<sup>446</sup>

Q. Is it not true that the market price of Associated Gas and Electric Company Class A [stock] at the date when Eastern Utilities Investing Corporation acquired it was higher than it would have been if Associated Gas and Electric Company directly, or through Associated Gas and Electric Securities Company, had not been making purchases in the open market of the Class A stock?

A. No: I do not believe it would—that is just my opinion.

Q. You disbelieve for the same reason you have already stated?

A. Yes.

Q. It is possible it was higher as a result of those purchases; is that not right?

A. Oh, yes.

Q. And you would not definitely testify under oath it was not higher as a result of those purchases?

A. No: I would not testify definitely that it was not higher, nor would I testify definitely that it was higher, because I do not think there is any way you can really tell.

Q. But there is a certain likelihood that the price was higher because of those purchases?

A. There is such a possibility.

Q. Associated Gas and Electric Securities Company was under the same control at the top as Eastern Utilities Investing Corporation at that time, was it not?

A. Yes.

Q. And Associated Gas and Electric Securities Company got at least part of its funds from Associated Gas and Electric Company; is that not right?

A. Yes.

Q. And at least part of these funds which came from Associated Gas and Electric Company were the proceeds of the Eastern Utilities Investing Corporation debentures; is that not true?

A. That is correct.

Q. Then is it not fair to say that the proceeds of Eastern Utilities Investing Corporation debentures were used in part by the "System" to finance purchases which had an effect in raising the price of a security which was put into the Eastern Utilities Investing Corporation portfolio in place of those proceeds and at that higher price?

<sup>444</sup> See *supra*, note 355.

<sup>445</sup> See *supra*, p. 687.

<sup>446</sup> *Op. cit. supra*, note 6, at 24743-5.



A. Well, I think it is fair to say that the proceeds from the sale of the Eastern Utilities Investing Corporation debentures would find their way into the treasury of Associated Gas and Electric Company or Associated Gas and Electric Company advanced funds to Associated Gas and Electric Securities Company and that Associated Gas and Electric Securities Company in turn did buy Class A stock in the market and that by having bought that Class A stock in the market they may have affected the price at which the stock was selling, and that some of the stock which was so purchased was sold to Eastern Utilities Investing Corporation at the market which was established in whatever way it was established.

Q. And that some of the proceeds of the Eastern Utilities Investing Corporation debenture issue were used to make purchases which may have raised the price of Class A stock at the time Eastern Utilities Investing Corporation acquired 199,000 shares of it?

A. Yes; very definitely.

The bulk of the 102,000 shares of Associated Gas and Electric Company Class A stock which remained in the portfolio of Eastern Utilities Investing Corporation at the end of April 1929, was held by the Corporation until November 1930. In November 1930, the Corporation sold to Associated Gas and Electric Securities Company, Inc., 306,124 shares of the Class A stock of their common parent, Associated Gas and Electric Company, at \$32.84 per share,<sup>447</sup> representing a loss to Eastern Utilities Investing Corporation on the original 102,000 shares of \$24.16 per share, or \$2,464,320 on that investment. The proceeds were used to purchase 153,062 shares of Associated Gas and Electric Company \$4 preference stock at \$65.67 per share.<sup>448</sup> In other words, Eastern Utilities Investing Corporation was caused to switch from the Class A stock to the \$4 preference stock, receiving by this transaction half the number of shares at twice the price per share. Both the sales price of the Class A and the purchase price of the \$4 preference were substantially above the market prices at the time, but no justification was offered for the exact ratio of 2 to 1 in the value of these two classes of securities. Had the Class A for which the Corporation had paid \$57 per share been sold at what was then quoted as the market price of approximately \$20 per share,<sup>449</sup> Eastern Utilities Investing Corporation would have realized a loss on that investment of \$37 per share, or \$3,774,000 for the 102,000 shares it had purchased in April 1929. Also, on the basis of the then existing market price, an unrealized loss of approximately \$1,300,000 was carried over to the new investment in the \$4 preference stock, whereas proper accounting would have required the realization of the full loss on an investment actually sold.

Mr. Stix, when examined on the possible conflict of interest in the various transactions effected by the Corporation, testified:<sup>450</sup>

A. Yes; there were a lot of transfers in and out of Eastern Utilities Investing Corporation.

Q. And in considering those transfers the directors of Eastern Utilities Investing Corporation who were also connected with the purchasing company

<sup>447</sup> Id., Commission's Exhibit No. 3771, Part VII, Table 33.

<sup>448</sup> Id., Commission's Exhibit No. 3771, Part VII, Table 32.

<sup>449</sup> Id., Commission's Exhibit No. 3771, Part VII, Table 33.

<sup>450</sup> Id., at 23332-3.

would have to consider the transaction from two conflicting points of view; isn't that right?

A. No; I don't think so.

Q. Don't you think the buyer and seller usually have a conflicting point of view?

A. No, sir.

Q. You don't think the buyer usually wants to get as high a price as he can—the seller wants to get as high a price as he can and the buyer wants to pay as little as he can?

A. Yes; when they are not in the same family.

Q. But really Eastern Utilities Investing Corporation and the purchasing company were in the same family?

A. Exactly.

Q. But the minority stockholders of Eastern Utilities Investing Corporation were not in the same family, were they?

A. Well, we thought they were. We treated them as though they were.

Q. But it is at least conceivable that the purchasing company in the family would pay less for the stock than the minority interest of Eastern Utilities Investing Corporation would think fair, isn't that right?

A. Oh, yes; there are all kinds of opinions about what things are worth.

#### b. Associated Gas and Electric Company \$5 Preferred Stock

Eastern Utilities Investing Corporation, immediately after the issuance of its debentures, had an investment of \$7,349,920 in Associated Gas and Electric Company \$5 preferred stock.<sup>451</sup> Additional blocks of this \$5 preferred stock were acquired from time to time until October 1929, when the corporation sold 130,000 shares of this \$5 preferred stock for \$11,700,000, the approximate market price, and purchased in lieu thereof \$12,300,000 principal amount of Associated Gas and Electric Company 6% debentures for \$11,685,000.<sup>452</sup>

A portion of these 6% debentures, \$9,916,300 principal amount at par, were sold in May 1930. During that month, Eastern Utilities Investing Corporation paid to Associated Utilities Investing Corporation \$9,916,300 for 99,163 shares of second preferred stock of Gas and Electric Associates, an affiliate of Associated Gas and Electric Company. In September 1930, Eastern Utilities Investing Corporation sold back 63,163 shares of that second preferred stock to Associated Utilities Investing Corporation and repurchased 6% debentures, a transaction involving \$6,317,500.<sup>453</sup> These transactions illustrate the size and rapidity of shifts in and out of the securities of the System which Eastern Utilities Investing Corporation was required to make in transactions with "System" companies.

#### c. General Gas & Electric Corporation Class B Common

Included in the securities which Eastern Utilities Investing Corporation received in lieu of the cash proceeds of its debenture issued in April 1929 were 150,000 shares of General Gas & Electric Corporation's Class B common stock at \$95 per share, or a total cost of \$14,250,000. In December 1929, after the stock market collapse, the Cor-

<sup>451</sup> See *supra*, pp. 701-2. *Portfolio of Eastern Utilities Investing Corporation in April 1929*.

<sup>452</sup> *Op. cit. supra*, note 6, Commission's Exhibit No. 3771, Part VII, Tables 32 and 33.

<sup>453</sup> *Ibid.*

poration purchased 48,430 additional shares from a "System affiliate," Associated General Electric Corporation, at a cost of \$103.76 per share, or \$5,025,097,<sup>454</sup> or at \$8.76 per share more than Eastern Utilities Investing Corporation had paid in April of that year when the market was rising. This latter cost price represented the liquidating value of the stock plus a pro rata share of the earned surplus. The possibility of realization on the surplus of General Gas & Electric Corporation was of course, problematical. Apparently it was not even contended that the price of \$103.76 bore any relation to the market price of these securities, but only that it represented the involuntary liquidating value plus a pro rata share of the earned surplus of General Gas & Electric Corporation. Neither the reason for the selection of this method of valuation nor the method by which such large blocks of stock in the portfolio of General Gas & Electric Corporation could be liquidated at carrying value was disclosed. The greater part of the portfolio of General Gas consisted of securities of its parent, Associated Gas and Electric Company.<sup>455</sup> It is questionable that such large blocks of Associated securities could be sold without so depressing their market price, with the consequent depression of the value of the General Gas & Electric Corporation stock.

#### d. Stocks of Service Companies of the "System"

The portfolio of Eastern Utilities Investing Corporation in April 1929 also included 7% preferred stock of the following service companies of the "System."<sup>456</sup>

Utility Management Corp., 50,000 shares-----	\$5, 000, 000
Consumers Construction Co., 50,000 shares-----	5, 000, 000
The J. G. White Management Corp., 1,000 shares-----	100, 000
Total-----	10, 100, 000

In December 1930, Eastern Utilities Investing Corporation exchanged all these preferred stocks of these service companies at an assigned value of \$10,100,000 for 108,775 shares of Associated Gas and Electric Company \$6.50 preference stock at an assigned value of \$92.85. The purchase price which Eastern Utilities Investing Corporation thus paid for these \$6.50 preference stocks was \$4.35 per share, or \$473,-171.25 above the high market price of \$88.50 per share and \$12.85 per share or \$1,397,758.75 above the low market price of \$80 per share.<sup>457</sup>

And Mr. Stix testified that the service company preferred stocks which Eastern Utilities Investing Corporation thus gave up to Associated Utilities Investing Corporation,<sup>458</sup> another "System" company, were the best securities Eastern Utilities Investing Corporation had in its portfolio at the time.<sup>459</sup>

<sup>454</sup> Id., Commission's Exhibit No. 3771, Part VII, Table 32.

<sup>455</sup> The extent of these cross holdings and their effect on the General Gas & Electric Corporation portfolio are indicated in that portion of the Federal Trade Commission Report dealing with General Gas & Electric Corporation as well as in the report on the same company made by the New York Stock Exchange. (Id., Commission's Exhibit No. 3820.)

<sup>456</sup> See *supra*, pp. 701-2, *Portfolio of Eastern Utilities Investing Corporation in April 1929*.

<sup>457</sup> *Op. cit. supra*, note 6, Commission's Exhibit No. 3771, Part VII, Tables 32 and 33. These market quotations were supplied by representatives of the Associated System in answering the Commission's questionnaire.

<sup>458</sup> *Ibid.*

<sup>459</sup> *Op. cit. supra*, note 46, at 2438-41.

## e. Utilities Power &amp; Light Corporation Class B Stock

On March 31, 1929, immediately prior to the receipt of the proceeds of the debenture issue, Eastern Utilities Investing Corporation owned 226,201 shares of the Class B voting trust certificates of Utilities Power & Light Corporation<sup>460</sup> which were carried at \$43.02 per share or \$9,731,442.<sup>461</sup> Most of these shares were acquired in 1928 at a market price of approximately \$28 per share.<sup>462</sup> The shares were written up from \$28 to \$43, a total write-up of approximately \$3,000,000, prior to the debenture issue.<sup>463</sup>

## 4. SUMMARY

The above-enumerated purchases, sales, and exchanges are but a few of the many large transactions which Eastern Utilities Investing Corporation made between April 1929 and June 1931. During the years 1929 and 1930 the total purchases amounted to \$87,963,876.01 and \$50,198,828.91, respectively, and the sales amounted to \$59,558,892.02 and \$55,722,605.15, respectively.<sup>464</sup> Despite the fact that the offering circular used in connection with the debentures stated that the holdings of the company were to be "for long-term investment," the average turn-over during these years was about 75% per year, which indicates that during this period the investment company bought and sold securities with an aggregate value per year equal to about 150% of the average market value of the portfolio during the year.<sup>465</sup> Through many of these transactions, the resources of Eastern Utilities Investing Corporation were used for the benefit of those in control of the Associated System.<sup>466</sup>

<sup>460</sup> The Associated System still has a substantial block of this class of stock of Utilities Power & Light Corporation. (*In the matter of Utilities Power & Light Corporation*, Commission Docket No. 52-10, Exhibit A.)

<sup>461</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3805.

<sup>462</sup> Id., Commission's Exhibit No. 3771, Part VII, Table 32.

<sup>463</sup> Id., Commission's Exhibit No. 3780, Haskins & Sells Report on General Audit of Accounts of Eastern Utilities Investing Corporation from January 1, 1928, to January 31, 1929.

<sup>464</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3771, Part VII, Tables 32 and 33.

<sup>465</sup> This turn-over rate was derived by dividing one-fourth the value of the aggregate portfolio transactions (after adjustment for the receipt of the proceeds from the company's debenture issue) by a weighted annual average market value of the portfolio during the period.

<sup>466</sup> See supra. In addition to the methods already described, the Associated Gas & Electric System used the credit of Eastern Utilities Investing Corporation by causing that company to borrow substantial sums from banks.

On July 30, 1930, Eastern Utilities Investing Corporation issued a note for \$1,500,000 with interest at  $4\frac{3}{4}\%$  per annum payable to The Public National Bank and Trust Company of New York. On that day, Eastern Utilities Investing Corporation purchased 13,247 shares of Associated Gas and Electric Company \$5 preferred stock for an aggregate cost of \$1,191,793 from General Gas & Electric Corporation. (Op. cit. supra, note 6, Commission's Exhibit No. 3836.) It is evident that the Eastern Utilities Investing Corporation was caused to borrow this money from the bank to effect this purchase. (This purchase transaction appears on the same statement submitted by the corporation showing the bank loan.) The note which was due on January 31, 1931, was finally paid by Eastern Utilities Investing Corporation on May 6, 1931, by an advance of \$1,500,000 on open account from Associated Gas and Electric Company to Eastern Utilities Investing Corporation. (Op. cit. supra, note 6, Commission's Exhibit No. 3836.) This open account advance was paid in May 1931 by the delivery to Associated Gas and Electric Company of 14,456 shares of its \$6.50 preference stock out of the portfolio of Eastern Utilities Investing Corporation. (Id., at 26050, and Commission's Exhibit No. 3771, Part VII, Table 33.)

Another loan was obtained by Eastern Utilities Investing Corporation in January 1932 from The Public National Bank and Trust Company of New York. Although, as at

December 31, 1931, Eastern Utilities Investing Corporation had investments which had cost it approximately \$60,000,000 (id., Commission's Exhibit No. 3771, Part I, certified balance sheet in annual report for the year ended December 31, 1931), the comptroller of the company admitted that "what it had in its portfolio was not suitable for collateral" to secure a \$325,000 loan. (Id., at 25737.)

In this connection, Mr. Stix testified (ibid.) :

Q. Would you not say that the effect of these transactions was that Eastern Utilities Investing Corporation purchased the collateral securities from Associated Gas and Electric Company and sold to it in return the Cities Service notes and the Associated Gas and Electric Company \$6.50 cumulative preference stock?

A. Yes.

Q. And Eastern Utilities Investing Corporation used these securities which it had purchased in that way as collateral securing its \$325,000 note?

A. That is correct.

Q. Now, why did Eastern Utilities Investing Corporation have to purchase such collateral?

A. For the reason that what it had in its portfolio was not suitable for collateral.

In preparation for the loan, Eastern Utilities Investing Corporation purchased from Associated Gas and Electric Company fixed interest obligations, primarily of operating subsidiaries of Associated Gas and Electric Company, to be used as collateral for the loan. (Id., at 25753.) These securities were carried on the books of Eastern Utilities Investing Corporation at \$474,500. (Id., at 25735-6.) At the same time, January 1932, Eastern Utilities Investing Corporation sold to Associated Gas and Electric Company, \$200,000 principal amount of Cities Service Company 6% notes and 2,650 shares of Associated Gas and Electric Company \$6.50 preference stock. (Ibid.) On January 23, 1932, Eastern Utilities Investing Corporation used the securities it received on this exchange as collateral to secure a \$325,000 note payable to The Public National Bank and Trust Company of New York. (Id., Commission's Exhibit No. 3817; collateral securities are shown on the face of the note.) Eastern Utilities Investing Corporation through its subsidiary, then purchased 11,604 shares of stock of The Public National Bank and Trust Company of New York at \$24.50 per share for a total of \$284,298 in cash, part of which cash consisted of money lent by the bank, from the Public National Corporation, an affiliate of the bank. (Id., at 25741.) Thus, Eastern Utilities Investing Corporation exchanged its portfolio securities for other securities, which were pledged as collateral for a loan from The Public National Bank and Trust Company of New York to raise cash to buy the stock of that bank. (Id., at 25742.)

The Public National Bank and Trust Company of New York did considerable business with various companies of the "System" and blocks of this bank stock were owned by H. C. Hopson personally and by some of the "System" companies. (Derived from supplementary information supplied the Commission—affidavit verified August 4, 1938, of Harold A. Meriam, and assistant vice president of The Public National Bank and Trust Company of New York.) This bank also had acted as depository to receive \$18,800,000 principal amount of Eastern Utilities Investing Corporation debentures pursuant to public exchange offers. (Op. cit. supra, note 41, p. 344.)

Some light may be thrown on the purpose of the transaction by a letter dated February 2, 1932, in which Eastern Utilities Investing Corporation gave Public Utility Investing Corporation a "call" (option to purchase during a given period at a stated price) on that bank stock during the succeeding five years at \$24.50 per share (op. cit. supra, note 6, at 25742 and Commission's Exhibit No. 3817), the same price at which Eastern Utilities Investing Corporation, through its subsidiary, had just acquired the stock. The record does not disclose the consideration, if any, received by Eastern Utilities Investing Corporation for this call or any benefit the transaction might have been to Eastern Utilities Investing Corporation. It will be remembered that Mr. Hopson was president, director, and a large holder of the common stock of Public Utility Investing Corporation, and that 10,000 shares of Public Utility Investing Corporation preferred stock had been, on July 31, 1927, put into Eastern Utilities Investing Corporation's portfolio. (See supra, pp. 652-4, *Public Utility Investing Corporation*, and op. cit. supra, note 6, at 23394, and Commission's Exhibit No. 3778.)

On June 24, 1932, the note of \$325,000 was reduced to \$175,000 and was paid in full on July 25, 1932. (Id., Commission's Exhibit No. 3817; face of note so marked.) Associated Gas and Electric Corporation (Delaware) advanced the funds to pay off the loan and received the collateral securing the loan. All of the securities originally in the portfolio of Eastern Utilities Investing Corporation which were exchanged for the securities used as collateral for the loan, however, could not be returned since the \$200,000 Cities Service Company note included in the block exchange, had matured in the meantime and the cash went to Associated Gas and Electric Company or Associated Gas and Electric Corporation. (Id., at 25755-6.) As a consequence, Eastern Utilities Investing Corporation virtually gave up \$200,000 in cash and received in exchange more securities of the Associated Gas & Electric System in lieu of the proceeds of the note. In lieu of the Cities Service notes

## H. Reacquisitions of Debentures and Portfolio Changes, June 1931 to June 1933—Attitude of the Bankers and of the Indenture Trustee

### 1. REACQUISITION BY THE "SYSTEM" OF EASTERN THROUGH VARIOUS EXCHANGE OFFERS UTILITIES INVESTING CORPORATION DEBENTURES

Through Eastern Utilities Investing Corporation, Associated Gas and Electric Company had gained a utility system and had raised \$32,812,500, which Associated Gas and Electric Company used for its own expansion, particularly in the acquisition of General Gas & Electric Corporation.<sup>467</sup> However, by June of 1931 Eastern Utilities Investing Corporation's debentures had substantially declined in market price, reaching a price of \$53 per \$100 debenture.<sup>468</sup> Their value, of course, depended almost entirely upon the value of securities of Associated System companies.

The Associated Gas and Electric Company, through various of its subsidiary companies, began an active program consisting of a series of offers to shift the holders of the securities of Eastern Utilities Investing Corporation into Associated Gas and Electric Company securities. The first offer of exchange was made by Associated Gas and Electric Securities Company, Inc., on June 16, 1931, and offered for \$1,000 principal amount of Eastern Utilities Investing Corporation 5% debentures (with a market quotation of \$530) a \$1,000 principal amount of Associated Gas and Electric Company 4½% convertible debentures due 1949<sup>469</sup> (with a market quotation of \$660).<sup>470</sup> The acceptance of this offer was immediately recommended by Harris, Forbes & Company, and Halsey, Stuart & Co., Inc.,<sup>471</sup> the original underwriters of the Eastern Utilities Investing

of \$200,000 plus accrued interest Eastern Utilities Investing Corporation received \$258,000 principal amount of Mohawk Valley Company 6's due 1981, valued at \$206,400, of which \$6,400 was an open account. (Id., Commission's Exhibit No. 3771, Part VII, Tables 32 and 33.) These bonds were ultimately used to purchase \$310,000 principal amount of its own debentures from Associated Gas and Electric Company, at a price of about \$65 when the market price was \$30. (Id., Commission's Exhibit No. 3772, Item 19.) Substantial amounts of Associated Gas and Electric Company \$6.50 preference stock remained in the portfolio when the company went into 77B proceedings. (Id., Commission's Exhibit No. 3783, p. 18.)

Mr. Stix testified (id., at 25756-7) :

Q. Now, to summarize this operation, would you not say that Eastern Utilities Investing Corporation purchased collateral securities from Associated Gas and Electric Company, giving in exchange some of its portfolio securities; then pledged its collateral securities to a \$325,000 note, used most of the proceeds of this note to buy bank stock of the bank which lent the money to Eastern Utilities Investing Corporation, and then all of these operations were reversed and the note was paid off?

A. Yes; I think that is a fair interpretation of what happened.

Q. In other words, was not Eastern Utilities Investing Corporation used as a vehicle to borrow money to buy bank stock which was subject to call given to Public Utilities Investing Corporation?

A. I think very definitely Eastern Utilities Investing Corporation's credit was used to help Associated and that call may have some significance, too.

Q. Well, in this case Eastern Utilities Investing Corporation's credit was used to help Public Utilities Investing Corporation; is that not right?

A. I think it was of assistance to them.

<sup>467</sup> See *supra*, p. 685.

<sup>468</sup> *Op. cit. supra*, note 6, Commission's Exhibit No. 3826. By September 1931 The New York Trust Company, the trustee of the debenture issue, was put on notice of the fact that the debentures were selling around 36. (Id., at 23746.)

<sup>469</sup> Id., Commission's Exhibit No. 3772, Item 38.

<sup>470</sup> Id., Commission's Exhibit No. 3826.

<sup>471</sup> Id., Commission's Exhibit No. 3843, Item 19. See copy of letter dated June 15, 1931, to debenture holders from Harris, Forbes & Company and Halsey, Stuart & Co., Inc.

Corporation debentures. Subsequently, various offers were made to the holders of these debentures to exchange these securities for Associated Gas and Electric Company 5% convertible certificates, Associated Gas and Electric Company 4½% debentures due 1958, Associated Gas and Electric Company convertible obligations, Series A, Associated Gas and Electric Company 4% debentures due 1983, and Associated Gas and Electric Company 5% income debentures due 1983.<sup>472</sup>

The convertible certificates and the convertible obligations were practically the same security under different names, and both had the unusual feature that the issuer had the option to convert these securities, which apparently were evidences of debt, into preferred stock. The holder also had the usual similar option.

In each exchange offer the security offered had a market quotation higher than that of the Eastern Utilities Investing Corporation debentures exchangeable therefor.<sup>473</sup> This no doubt was intended to induce acceptance of the offer.

As a result of these numerous exchange offers, the Associated Gas & Electric System had acquired, up to the end of the year 1931, \$18,398,000 principal amount of the Eastern Utilities Investing Corporation debentures, and had paid for these debentures the following:<sup>474</sup>

\$672,329 cash;

\$16,705,000 principal amount of Associated Gas and Electric Company 4½% Convertible Gold Debentures due 1949;

\$221,600 principal amount of Associated Gas and Electric Company 4½% Gold Debenture Bonds, Consolidated Refunding Series, due 1958;

\$489,000 principal amount of Associated Gas and Electric Company 5% convertible certificates.<sup>475</sup>

These offers were not only made by Associated Gas and Electric Securities Company, Inc., which was apparently a "System" company, but were also made by The General Finance Corporation,<sup>476</sup> which was not disclosed to the security holders as a "System" company. Mr. Stix testified, when examined on this nondisclosure:<sup>477</sup>

Q. Didn't the use of another company encourage debenture holders to believe, not only that more than one company was recommending the exchange of these debentures, but also that an independent company, without the name "Associated" in its title, was recommending these exchanges?

A. It may have had that effect.

\* \* \* \* \*

Q. Did the public know that General Finance Corporation was a part of the same system of which Eastern Utilities Investing Corporation was a part?

A. Well, I don't know except that they were of the same address. The letters didn't so state.

<sup>472</sup> Id., Commission's Exhibit No. 3826.

<sup>473</sup> Ibid.

<sup>474</sup> Id., Commission's Exhibit No. 3772, Item 19. See also Commission's Exhibit No. 3775.

<sup>475</sup> Changed by the company first into convertible obligations, and, in June 1932, into convertible obligations due in the year 2002. (Id., at 25982.)

<sup>476</sup> The General Finance Corporation procured the names of the holders from the records of Eastern Utilities Investing Corporation. It was a subsidiary of Associated Gas and Electric Company but none of these letters referred to its connection with the "System." (Id., at 25999-26000.)

<sup>477</sup> Id., at 26001, 25999.



In addition, Eastern Utilities Investing Corporation, from time to time, recommended to its own security holders the acceptance of offers made by these "System" companies.<sup>478</sup>

Although the nature of the offers, and the emphasis in presenting them, varied from time to time, the program of inducing Eastern Utilities Investing Corporation investors to give up their claims against the corporation and take securities of Associated Gas and Electric Company persisted from June 1931, until July 26, 1937, the date of the confirmation of the amended reorganization plan.<sup>479</sup> and a few have been made since then.<sup>480</sup> The initial and amended plans of reorganization of Eastern Utilities Investing Corporation provided for exchange of Eastern Utilities Investing Corporation securities for securities of Associated Gas and Electric Company as had the original exchange offers.

The intensity of the campaign to reacquire the Eastern Utilities Investing Corporation debentures is revealed by the number of offers made to the holders. Mr. Stix testified: <sup>481</sup>

Q. Now, my count of the number of circulars put out by General Finance Corporation and sent to Eastern Utilities Investing Corporation debenture holders with reference to its exchange offers, is that there were fifteen of them. That does not strike you as being too many, does it?

A. It does not .

\* \* \* \* \*

Q. Now, my count of the offers made by Associated Gas and Electric Securities Company is that in approximately five months the Eastern Utilities Investing Corporation debenture holders received five such exchange offers. Do you find anything wrong with that?

A. No.

A similar intensive campaign to induce the exchange of the other securities of Eastern Utilities Investing Corporation for securities of the "System" was conducted. Mr. Stix testified: <sup>482</sup>

Q. And in respect to the exchange offers to the holders of Eastern Utilities Investing Corporation preferred stock, starting in November of 1931, there were apparently ten exchange offers sent to them. Do you find anything wrong with that?

A. No.

Q. And in respect to the exchange offers sent to the holders of Eastern Utilities Investing Corporation \$6 preferred stock, there were apparently nine offers sent to them. Do you find anything wrong with that?

A. No.

Q. In respect to the exchange offers sent to the holders of Eastern Utilities Investing Corporation participating preference stock starting in November 1931,

<sup>478</sup> Id., Commission's Exhibit No. 3772, Item 39.

<sup>479</sup> Id., Commission's Exhibits Nos. 3784 and 3785. The terms of the amended reorganization plan, which was confirmed by the court on July 26, 1937, provide for an exchange of Associated Gas and Electric Company securities for Eastern Utilities Investing Corporation securities.

<sup>480</sup> See *In the matter of Associated Gas and Electric Company* before the Securities and Exchange Commission Docket No. 1-1810, p. 438, where, on April 28, 1939, Mr. Stix testified.

Q. These exchange offers continued up until July 26, 1937, the date of the confirmation of the reorganization plan of Eastern Utilities Investing Corporation?

A. Yes; and a few have been made since then too.

<sup>481</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3826, at 25999-6000.

<sup>482</sup> Id., at 26001-2.



there were apparently nine offers sent to them. Do you find anything wrong with that?

A. No; that is correct.

Q. Now, with respect to the exchange offers sent to holders of Eastern Utilities Investing Corporation Class A stock, there were apparently eight letters and one telegram sent to them. Do you find anything wrong with that?

A. That is correct.

Q. So that, according to my [count], the Eastern Utilities Investing Corporation security holders received a sum total of sixty-two letters and one telegram offering exchanges in various securities of the Associated Gas & Electric System. Does that seem right?

A. That is right. The record will show that they did not all go to the same security holders.

Q. Now, if a holder of Eastern Utilities Investing Corporation debentures did not accept any exchange offer, he would have received a total of fifteen offering letters of which ten would have been received in less than one year or almost one a month. Do you find any fault with that?

A. That is correct.

The New York Trust Company, the trustee of the debenture issue, did not keep up with the exchange offers.<sup>483</sup> In response to any inquiries, the trustee merely made available in the form called for by the indenture, the formal certificates filed by the officers of Eastern Utilities Investing Corporation, and then usually referred the inquirer to Eastern Utilities Investing Corporation.<sup>484</sup>

The attitude of The New York Trust Company is apparent in a memorandum from the trustee's own investment committee, dated February 11, 1932, to Mr. Downing, the officer of The New York Trust Company in charge of its Corporate Trust Department:<sup>485</sup>

Our Investment Committee does not care for any Associated Gas and Electric securities, particularly the Eastern Utilities Investing Corporation's bonds.

As The New York Trust Company is Trustee for this issue, we hesitate about expressing an opinion to individuals and the Investment Committee suggested that the inquiry be handled directly by the Corporate Trust Department.

The only advice given by the trustee to inquirers was to refer them to the one-page certificates filed with the trustee by Eastern Utilities Investing Corporation officers and Hopson service companies and, for any further information, to refer them to the Eastern Utilities Investing Corporation, which was dominated by the same personalities who dominated the corporations making the exchange offers. Mr. Cooper, an officer of The New York Trust Company, testified:<sup>486</sup>

Q. And because The New York Trust Company was trustee of the issue, the investment committee which usually gives investment advice to inquirers referred such inquiries to the corporate trust department?

A. That is correct.

Q. As the result of this memorandum [supra], did the corporate trust department answer inquiries about the Eastern Utilities Investing Corporation debentures?

A. Yes, sir.

<sup>483</sup> Id., at 23759.

<sup>484</sup> Id., at 23787-8.

<sup>485</sup> Id., Commission's Exhibit No. 3782, Item 36-A.

<sup>486</sup> Id., at 23787-90.

Q. How many inquiries did it answer?

A. Quite a number I would say.

Q. \* \* \* What was the nature of the information which the corporate trust department gave in response to these inquiries?

A. We gave in response to such inquiries information which we had available, and usually referred the inquirer to the company for further information.

Q. That is, referred the inquirer to the Eastern Utilities Investing Corporation?

A. Yes, sir.

\* \* \* \* \*

Q. I believe you testified in response to these inquiries about the Eastern Utilities Investing Corporation debentures that you furnished such information as the Corporate Trust Department had available; isn't that right?

A. Yes.

Q. Of what did that information consist?

A. Well, we could enlighten the inquirers as to the terms of the indenture, about which there was considerable misapprehension. We could give them the amount of bonds outstanding.

Q. You could give them what?

A. The amount of bonds outstanding, and the information contained in certificates filed with us.

Q. And that was all that you could give them?

A. Yes, sir.

Q. If they had had a copy of the indenture, they could have turned it over to their own counsel for an opinion, could they not?

A. Yes; they didn't get any opinion from us as to the construction of the indenture.

Q. You merely showed them a copy of the indenture?

A. Or quoted from it.

Q. You never expressed an opinion as to its interpretation?

A. No.

Q. They could have obtained the amount of debentures outstanding from various well-known financial sources, could they not?

A. I believe so.

Q. And the information contained in the certificates wasn't of very much help to the inquirers, was it?

A. Not as to detail of the specific assets of the corporation.

The certificates, in the form called for by the indenture, contained no more than a statement by officers of Eastern Utilities Investing Corporation to the effect that the fair value of the company's assets had been computed in accordance with the indenture and aggregated a certain amount and "that the Company is not known to the signers of this certificate to be in default with respect to any of the terms and conditions of said Indenture." The certificates also contained a statement by a Hopson service company of the total amount of outstanding funded debt and the total amount of temporary indebtedness.<sup>487</sup> In view of the discussion later in this report as to the manner in which these amounts were determined, it is apparent that the information furnished by the Trustee to inquiring debenture holders was what the management of the Associated System said the total assets and debt of Eastern Utilities Investing Corporation were at certain dates. With only one exception, these figures were sup-

<sup>487</sup> Id., Commission's Exhibit No. 3787, Items 17, 17a, et seq.

plied only once a year and at least three months after the date to which they applied.<sup>488</sup>

In connection with the continuous campaign to switch the holders of preferred and Class A stocks of Eastern Utilities Investing Corporation<sup>489</sup> into other securities of the "System," a different approach was employed by the "System" from that which was employed with the debenture holders. As early as November 12, 1931, the possibility of default under the asset coverage provision (the "touch-off clause") of Eastern Utilities Investing Corporation debentures was emphasized in a letter to the holders of prior preferred stock of Eastern Utilities Investing Corporation:<sup>490</sup>

Should the value of the assets go below 125% of the amount of the debentures outstanding, an event of default would occur and the principal of all the debentures then outstanding, together with accrued and unpaid interest thereon, may by the trustee be declared to be forthwith due and payable.

However, the debenture holders, who might have taken some action to protect their interest in case of a default, were not apprised by the "System" that a default was imminent until February 16, 1933, fifteen months later,<sup>491</sup> when the bankers, Harris, Forbes & Company and Halsey, Stuart & Co., Inc., wrote them a letter saying, among other things:

The unprecedented decline in security values has made it apparent that an upturn in quoted values would be necessary to avoid such a default.

and urging acceptance of an exchange offer made the same day by The General Finance Corporation.<sup>492</sup>

By that time, a default under the indenture had already occurred,<sup>493</sup> but was not disclosed.<sup>494</sup> Three months later the Associated System, by a letter dated May 12, 1933, from The General Finance Corporation, admitted to debenture holders for the first time the imminence of default, using similar language:

The unprecedented decline in security values has made it apparent that a material upturn in quoted values would be necessary to avoid such a default.

The notice by the "System" of imminence of default actually was not given by the "System" in order to enable the debenture holders to assert their rights under the indenture but was coupled with a statement to the effect that liquidation of the company would return less than \$8.50 on a \$100 debenture, in a letter seeking to induce debenture holders to vote for the elimination from the indenture of the "protective provisions," the breach of which would constitute a default.<sup>495</sup>

The value of the assets of Eastern Utilities Investing Corporation had not suddenly declined from over 125% of the amount of debentures outstanding (the minimum asset coverage required by the indenture) to 8.5%. This decline had occurred gradually. Yet the

<sup>488</sup> Ibid. Also see the indenture.

<sup>489</sup> Id., Commission's Exhibit No. 3772, Items 40 to 44, inclusive.

<sup>490</sup> Id., Commission's Exhibit No. 3772, Item 40.

<sup>491</sup> Id., Commission's Exhibit No. 3772, Item 39.

<sup>492</sup> Id., Commission's Exhibit No. 3771, Part I.

<sup>493</sup> Id., at 24642.

<sup>494</sup> Id., at 25218-9.

<sup>495</sup> Id., Commission's Exhibit No. 3772, Item 39.

debenture holders were not informed of the long existing default. The letter of May 12, 1933 to debenture holders spoke of default as still only a future possibility.

The advisability of accepting the numerous exchange offers was manifestly a difficult problem for the security holders. Security holders sought counsel from their brokers, security dealers, or investment houses. However, commissions were paid by the "System" to the bankers who successfully recommended the acceptance of these exchange offers,<sup>496</sup> and as a consequence their advice may not have been entirely unbiased and free from pecuniary interest. Harris, Forbes & Company received \$27,911.62 in commissions for securing the deposit of \$3,217,000 amount of debentures, and Halsey, Stuart & Co., Inc., received \$38,553.74 in commissions for the debentures they caused to be deposited pursuant to various exchange offers.<sup>497</sup> Mr. Stix testified:<sup>498</sup>

Q. Now, how could the Eastern Utilities Investing Corporation security holders determine the advisability of these multitudinous exchange offers?

A. Well, I believe most of them referred the exchange offer to their broker or security dealer or investment house. Some of them may have decided for themselves.

Q. But the holder, and particularly the small holders, was confronted with a considerable amount of difficulty in making up his mind whether these offers were fair or not?

A. Yes; that is the unfortunate plight of the small holder all the time.

Q. And even the large holder would have to take up quite a number of different offers with his broker, if he had one, or with his investment advisor, if he had one?

A. Yes.

Q. Commissions were paid to bankers in connection with these exchange offers, were they not?

A. Yes; commissions were paid. I don't know up to what point. I know commissions were paid.

## 2. EXCHANGE OFFER OF JUNE 1931

As previously stated, on June 16, 1931, the price of the debentures had dropped to \$53.<sup>499</sup> According to the banker's memorandum, Mr. Hopson had "tired" of supporting the market for the debentures.<sup>500</sup> The portfolio was largely composed of Associated System securities.<sup>501</sup> Accordingly, only two years and three months after the debentures, which were to mature in 1954, 23 years later, were issued, Associated Gas and Electric Securities Company, Inc., wrote to the holders of

<sup>496</sup> See *infra*, p. 719.

<sup>497</sup> Derived from supplementary information supplied the Commission by Harris, Forbes & Company and Halsey, Stuart & Co., Inc. (tabulation supplied by Harris, Forbes & Company and letter dated August 29, 1938, from Halsey, Stuart & Co., Inc.). See also *op. cit. supra*, note 6, Commission's Exhibit No. 3843, Item 20. In a letter dated June 18, 1931, General Utilities Securities, Incorporated, offered Harris, Forbes & Company and Halsey, Stuart & Co., Inc., a commission of  $\frac{3}{4}$  of a point on all debentures deposited for exchange under the offer then current, and for the deposit of which these bankers were directly responsible.

<sup>498</sup> *Op. cit. supra*, note 6, at 26002-3.

<sup>499</sup> *Id.*, Commission's Exhibit No. 3826.

<sup>500</sup> *Id.*, Commission's Exhibit No. 3843, Item 15, memorandum dated May 18, 1931.

<sup>501</sup> See *supra*, pp. 700-1 and *id.*, Commission's Exhibit No. 3771.

the debentures offering securities of the Associated Gas and Electric Company in exchange for the debentures. On June 15, 1931, the bankers, Harris, Forbes & Company and Halsey, Stuart & Co., Inc., urged the acceptance of the offer of Associated Gas and Electric Securities Company, Inc., to exchange the Eastern Utilities Investing Corporation debentures on a par for par basis for the 4½% convertible gold debentures due 1949 of Associated Gas and Electric Company. The bankers, in a joint letter, stated: <sup>502</sup>

Under present market conditions the securities of investing companies, however, do not enjoy the same favor with the investing public as securities of companies controlling important groups of public utility properties. The offer to exchange Eastern Utilities Investing Corporation debentures for those of Associated Gas and Electric Company is being made to enable holders desirous of transferring their investment from the debenture of an investing corporation to that of a public utility corporation to do so without incurring the loss which would be necessary if the Eastern Utilities Investing Corporation debentures were to be sold under present market conditions and the proceeds reinvested.

We feel that the offer of exchange is distinctly in the interest of the holders of Eastern Utilities Investing Corporation debentures.

For securing deposits under this exchange offer, Halsey, Stuart & Co., Inc., received \$11,396.25 in commissions and Harris, Forbes & Company the same net amount. <sup>503</sup>

On June 16, 1931, the offer, as described above by the bankers, was made by Associated Gas and Electric Securities Company, Inc., to the holders of the debentures of Eastern Utilities Investing Corporation in a letter stating: <sup>504</sup>

The market action of the Eastern Utilities Investing Corporation 5% gold debentures, due 1954, has indicated that many of the holders of these debentures wish to dispose of their holdings, in spite of a satisfactory earnings showing for the year 1930 and assurance by the bankers, Messrs. Harris, Forbes & Company, who with Halsey, Stuart & Co., Inc., headed the syndicate which sold this issue, that the debentures were adequately protected. The selling is apparently due principally to the fact that investment company securities, such as those of Eastern Utilities Investing Corporation, are not in favor with the investing public, who seemingly fear for the safety of income and principal in face of the continued decline in security prices.

The reference to "investment company securities, such as those of Eastern Utilities Investing Corporation" being in disfavor carried with it the obvious implication that the Eastern Utilities Investing Corporation was a diversified investment company and that the securities offered by Associated Gas and Electric Company in exchange therefor were materially different in nature from the investment company securities. However, as has been indicated, the portfolio of Eastern Utilities Investing Corporation was loaded with Associated Gas & Electric System securities.

This offer was revocable by Associated Gas and Electric Company if less than \$5,000,000 principal amount of debentures were

<sup>502</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3772, Item 39.

<sup>503</sup> Derived from supplementary information supplied the Commission by Halsey, Stuart & Co., Inc., and Harris, Forbes & Company. Harris, Forbes & Company received \$14,253.75 but refunded \$2,857.50, retaining \$11,396.25.

<sup>504</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3772, Item 39.

offered for exchange and Associated Gas and Electric Company could refuse to accept exchanges in excess of \$10,000,000 principal amount. The offer was to expire on July 31, 1931 (one and one-half months after it was made), with the option to the offerer of extending the period for not exceeding thirty days.<sup>505</sup>

The letter of June 16, 1931, did not disclose that the offerer, Associated Gas and Electric Securities Company, Inc., was a subsidiary of Associated Gas and Electric Company except as this relationship could be guessed from the similarity of names; it did not disclose the fact that Associated Gas and Electric Company had at that time complete control over Eastern Utilities Investing Corporation and Associated Gas and Electric Securities Company, Inc.; nor did it disclose the contemplated disposition of the Eastern Utilities Investing Corporation debentures which were to be acquired by its affiliates, although actually Eastern Utilities Investing Corporation was about to undergo a partial liquidation.

By July 23, 1931, \$7,000,000 principal amount of debentures had been deposited pursuant to that offer. On July 31, 1931, or eight days later, with over \$10,000,000 principal amount deposited, the period of this offer was extended to August 31, 1931, and the amount to be accepted was increased to \$15,000,000.<sup>506</sup>

When examined as to whether the trustee of the debenture issue kept itself informed of the exchange offers, Mr. Cooper of The New York Trust Company testified:<sup>507</sup>

Q. Did The New York Trust Company make any attempt to keep up to date with offers made in exchange for the debentures for which it was trustee?

A. Not as trustee; it did not.

Q. But did you in any other capacity?

A. I don't know.

### 3. PORTFOLIO SWITCH OF SEPTEMBER 30, 1931

On September 29, 1931, the board of directors of Eastern Utilities Investing Corporation, composed of Associated selected individuals, authorized the exchange of certain "System" securities and all except two of the remaining "non-System" securities in the portfolio of that corporation for securities to be selected by the company's officers who were also individuals connected with the "System." Three issues of Associated Gas and Electric Company were selected. Mr. Stix selected these securities early in October after the quarterly statement was prepared; but the transaction was consummated as of September 30, 1931.<sup>508</sup> Mr. Stix stated that the exchange of the list of portfolio securities for the three Associated Gas and Electric Company issues of securities, as far as he was concerned, was solely on

<sup>505</sup> Ibid. Apparently, the real purposes of these limitations were to expedite the exchange, and, apparently, the more restrictions imposed by the offer, the greater would be this effect.

<sup>506</sup> Ibid.

<sup>507</sup> Id., at 23759. It will be recalled that the investment committee of the trustee had, in a memorandum dated February 11, 1932, to the trust department, expressed its opinion with respect to the Eastern Utilities Investing Corporation debentures and the securities of the Associated Gas and Electric Company, saying "Our Investment Committee does not care for any Associated Gas and Electric securities, particularly the Eastern Utilities Investing Corporation's bonds." (Id., Commission's Exhibit No. 3782, Item 36-A.)

<sup>508</sup> Id., Commission's Exhibit No. 3819.

the basis of their income; and that he did not consider intrinsic or market value of the securities exchanged.<sup>509</sup> He testified:<sup>510</sup>

Q. \* \* \* Was the amount of prospective income taken into consideration on the securities received in the 1931 exchange?

A. Yes; that was the basis upon which the exchange was made \* \* \* so that Eastern Utilities Investing Corporation would have securities which would produce to them enough income to be able to service the securities which were outstanding.

Q. In making that exchange September 30, 1931, did you consider anything more than the income from the securities which you had accepted in the exchange?

A. I didn't, but others that had to do with it may have.

Q. But you never considered the intrinsic worth or value of the incoming securities or their market value at the time of the exchange?

A. I didn't.

#### a. Sixty Different Issues in the Portfolio Exchanged for Three Issues of Associated Gas and Electric Company Securities

The securities selected by Mr. Stix consisted of three blocks of securities as follows:

68,442 shares of Associated Gas and Electric Company \$5 preferred stock.

26,838 shares of Associated Gas and Electric Company \$6.50 cumulative preferred stock.

\$35,000,000 principal amount of Associated Gas and Electric Company 5% convertible certificates.<sup>511</sup>

More than sixty different issues of securities in the portfolio of Eastern Utilities Investing Corporation were exchanged for these three blocks.<sup>512</sup> These three blocks of securities were entered on the books of Eastern Utilities Investing Corporation at an aggregate of \$36,264,210, which was approximately the carrying value of the securities which Eastern Utilities Investing Corporation gave in exchange.<sup>513</sup> The \$35,000,000 principal amount of Associated Gas and Electric Company convertible certificates were valued at \$70 per \$100 principal amount or a total of \$24,500,000.<sup>514</sup> No market transactions had taken place in these certificates at the time.<sup>515</sup> The figure of \$70 was based only on a bid which one of Associated Gas and Electric Company's specialists said had been placed.<sup>516</sup> Mr. Stix testified:<sup>517</sup>

<sup>509</sup> Id., at 25020.

<sup>510</sup> Op. cit. supra, note 46, pp. 1133-5.

<sup>511</sup> Id., Commission's Exhibit No. 3819. The Associated Gas and Electric Company 5% convertible certificates were the same security offered to debenture holders in exchange for their Eastern Utilities Investing Corporation debentures by offer dated September 28, 1931, by Associated Gas and Electric Securities Company, Inc. Consequently, even though a debenture holder refused to exchange, he had nevertheless acquired without his knowledge an indirect interest in the convertible certificates substituted for part of the prior portfolio.

<sup>512</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3808, Item 11.

<sup>513</sup> Ibid.

<sup>514</sup> Id., Exhibit A to Mr. Cromwell's testimony.

<sup>515</sup> Id., Commission's Exhibit No. 3856.

<sup>516</sup> Id., Exhibit A to Mr. Cromwell's testimony.

<sup>517</sup> Id., at 26998.

Q. What did you know about the market for \$35,000,000 of convertible certificates?

A. I knew they were worth about 50.

Q. At the end of September, 1931?

A. About that time, yes.

These 5% convertible certificates in the principal amount of \$35,000,000 were selected because it was stated by Mr. Stix they would, as long as interest was paid on them, enable Eastern Utilities Investing Corporation to service its outstanding \$35,000,000 principal amount of 5% debentures. These convertible certificates were convertible at the issuer's option at any time into \$5 dividend series preferred stock of the issuer, and were also convertible at the holder's option into \$5 cumulative preference stock of the issuer.<sup>518</sup> Both conversion rights called for one share of stock for each \$100 of convertible obligations.<sup>519</sup> However, at a meeting of the directors of Eastern Utilities Investing Corporation on October 20, 1931,<sup>520</sup> the directors who, as has been indicated, were individuals connected with the "System", authorized a written agreement with Associated Gas and Electric Company confirming an oral understanding with that company that Eastern Utilities Investing Corporation would not exercise its right to convert the convertible certificates which it held in its portfolio into the \$5 cumulative preference stock of Associated Gas and Electric Company. The effect of that agreement was to make the \$35,000,000 of 5% convertible certificates of Associated Gas and Electric Company held by Eastern Utilities Investing Corporation convertible into \$5 preferred stock only at the option of Associated Gas and Electric Company, the controlling interest.

The designation of the Associated Gas and Electric Company convertible certificates, which Eastern Utilities Investing Corporation received as of September 30, 1931, was changed in November 1931 to convertible obligations, without any alteration of rights thereunder.<sup>521</sup>

In June 1932, Associated Gas and Electric Company called for conversion all the various convertible obligations and convertible debentures, which were convertible at its option, and offered to the holders the option to take in lieu of the Associated Gas and Electric Company \$5 preferred stock its 5% convertible obligations Series A due in 2002.<sup>522</sup> Associated Gas and Electric Company specified that if the holder failed to notify the company that he desired to accept the \$5 preferred stock, Associated Gas and Electric Company would send the convertible obligations, Series A due in 2002. Thus, although the holder had the right to receive the \$5 preferred stock, the Associated Gas and Electric Company put the burden on the holder of asking for that stock, or else he would receive the convertible obligation due in 2002.<sup>523</sup>

<sup>518</sup> Id., at 25977.

<sup>519</sup> Id., at 25976.

<sup>520</sup> At this same meeting, the directors refused to make the portfolio public.

<sup>521</sup> Op. cit. supra, note 6, at 25982.

<sup>522</sup> Id., at 25982. Mr. Stix testified (id., at 25983): "So, the holder of those certificates could do one of three things: he could send in his certificate and get convertible obligations; he could send in his certificate and get preferred stock; or he could keep his certificate and keep it the same as though he had sent it in and had received the convertible obligations."

<sup>523</sup> Id., at 25983-4.



b. General Gas & Electric Corporation Class B Voting Stock  
Exchanged for Class A Nonvoting Stock

In September 1931, in addition to switching the 60 different securities from the portfolio of Eastern Utilities Investing Corporation into the three blocks of Associated Gas and Electric Company securities previously mentioned, Eastern Utilities Investing Corporation was caused to give up its investment in the Class B (voting) stock of General Gas & Electric Corporation. It will be remembered that in aid of the plan of the Associated System to procure control of General Gas & Electric Corporation, Eastern Utilities Investing Corporation in April 1929 had been used by the "System" as a financing vehicle by being caused to acquire 150,000 shares of General Gas & Electric Corporation Class B common stock in the form of a due bill.<sup>524</sup> In December of that year Eastern Utilities Investing Corporation acquired 48,430 additional shares of the Class B common stock of General Gas & Electric Corporation.<sup>525</sup> Through a split-up of five for one, the holding of 198,430 shares became 992,150 shares of General Gas & Electric Corporation Class B stock.<sup>526</sup>

In September 1931 Eastern Utilities Investing Corporation was caused to transfer to Associated Gas and Electric Company these 992,150 shares of General Gas Class B stock at approximately \$20 a share for a total consideration of \$19,275,096 80,<sup>527</sup> payable in the same number of shares of General Gas & Electric Corporation Class A stock on a share-for-share basis. Mr. Stix testified:<sup>528</sup>

Q. So that the price per share of approximately \$20 a share was the same for each; isn't that right?

A. Yes; I don't think that the \$20 had any particular significance; it was the substitution of one for the other.

Q. Now, the market at the time of the exchange for the General Gas Class B. was what?

A. 5½ bid.

Q. And the market at the same time for the General Gas Class A was what?

A. Well, there was a low of—there are two prices, 4⅛ and 2⅞.

\* \* \* \* \*

Q. \* \* \* which shows the low to have been 2⅞ and the high 4⅛ on the New York Stock Exchange; isn't that right?

A. That is correct.

Mr. Stix refused to concede that on the basis of market price Eastern Utilities Investing Corporation was giving up several points per share by this exchange, explaining:<sup>529</sup>

Well, there was a difference of 1½ points in the quoted figures, but I don't think that the market figures here have any relationship whatsoever to a block of stock of 992,000-share size.

The market quotation of 5½ for General Gas & Electric Corporation Class B common stock was Associated Gas and Electric Company's

<sup>524</sup> Id., at 25050-1.

<sup>525</sup> Id., Commission's Exhibit No. 3771, Part VII, Table 32.

<sup>526</sup> Id., at 25065.

<sup>527</sup> Id., Commission's Exhibit No. 3771, Part VII, Table 33.

<sup>528</sup> Id., at 25066-7 and Commission's Exhibit No. 3771, Part VII, Table 32.

<sup>529</sup> Id., at 25077.

bid for this stock.<sup>530</sup> However, Associated Gas and Electric Company evidently was not interested in the A stock of General Gas & Electric Corporation. Mr. Stix testified as follows:<sup>531</sup>

Q. But it wasn't willing to pay that much for the General Gas Class A, was it?

A. Well, I don't know. I don't know that the Associated [Gas and Electric Company] was acquiring any General Gas Class A at that time. The B stock would naturally have more of an appeal to the Associated [Gas and Electric Company] than the A stock because the B stock carried with it voting control, and they were anxious to control 100%.

Q. Isn't that why Associated [Gas and Electric Company] took the General Gas Class B stock from Eastern Utilities Investing Corporation and substituted the General Gas Class A stock for it?

A. Very definitely.

Mr. Stix advanced as the only other reason for the switch that because the Class A preceded the Class B to a limited extent in order of distribution of dividends and rights on liquidation, "on a declining trend, that there was just a little more assurance that dividends could be paid on the Class A than on the Class B—other than that, there was no distinction."<sup>532</sup>

In view of Associated Gas and Electric Company's control of Eastern Utilities Investing Corporation, it is obvious that the reason for the exchange was to place the General Gas & Electric Corporation voting stock in Associated Gas and Electric Company's direct control at a time when Eastern Utilities Investing Corporation was becoming involved in financial difficulties.<sup>533</sup> The slight preference of the Class A over Class B was the rationalization for the exchange. "There was no free market for the Class B common stock at that time" and  $5\frac{5}{8}$  "was what was being bid by Associated for such shares as were still outstanding with the public."<sup>534</sup> Associated Gas and Electric Company through market transactions had put a higher price on the securities it received than on the securities it gave to Eastern Utilities Investing Corporation, although it was claimed that Eastern Utilities Investing Corporation was getting the better investment. The fact that during 1929, General Gas & Electric Corporation issued 170,000 shares of Class B at \$95 per share and 380,000 shares of Class A at only \$70 per share may be indicative that the Class B stock which Eastern Utilities Investing Corporation gave up was worth more than the same number of shares of Class A it received in return.<sup>535</sup>

<sup>530</sup> Id., at 25068.

<sup>531</sup> Id., at 25068-9.

<sup>532</sup> Id., at 25070. General Gas & Electric Corporation Class A stock had the right to receive 30 cents a share (after the five for one split up) before the General Gas & Electric Corporation Class B stock would receive a dividend. The Class A stock also had the right to receive \$5 on liquidation before the General Gas & Electric Corporation Class B would be entitled to any payment. But after the General Gas & Electric Corporation Class B received either 30 cents as a dividend or \$5 a share in liquidation, both classes would participate on an equal basis. (Ibid.)

<sup>533</sup> Id., at 26013.

<sup>534</sup> Id., at 25068.

<sup>535</sup> Id., at 25072.

Later, Eastern Utilities Investing Corporation was caused to sell its General Gas Class A stock to Associated Gas and Electric Company at 50¢ per share and realized a loss of about \$19,000,000.<sup>536</sup>

### c. Consequences of the Portfolio Switches of September 1931

As an indication of the ultimate aggregate loss which Eastern Utilities Investing Corporation suffered on the securities received by it from Associated Gas and Electric Company on the portfolio switches of September 1931, a tabulation prepared under the supervision of Mr. Stix shows that the portfolio then surrendered had by January 1938 a market value approximately \$16,000,000 greater than the market value in January 1938 of the securities received by Eastern Utilities Investing Corporation.<sup>537</sup> Even after taking into consideration cash and scrip dividends paid on the securities received, as compared with payments on securities surrendered, the portfolio switch of September 30, 1931, on the basis of recent prices, cost Eastern Utilities Investing Corporation over \$13,000,000.<sup>538</sup>

The September 1931 portfolio switch was an important point in the history of Eastern Utilities Investing Corporation apart from the large loss it occasioned the company. Associated Gas and Electric Company evidently considered that it had a sufficient amount of the debentures to control all of the activities of Eastern Utilities Investing Corporation. The exchange represented a change of policy from that of an active ostensible investment company to that of a company in liquidation, a role Eastern Utilities Investing Corporation had been caused to play once before.<sup>539</sup> The portfolio of Eastern Utilities Investing Corporation, as of the close of business on September 30, 1931, consisted of only the following:<sup>540</sup>

1,100,904 shares of General Gas & Electric Corporation <sup>541</sup> Class A stock, carried at	\$19, 818, 873
153,062 shares of Associated Gas and Electric Company \$4 cumulative preferred stock, carried at	12, 825, 939
75,000 shares of Associated Gas and Electric Company \$5 preferred stock, and 104,477 shares of Associated Gas and Electric Company \$6.50 cumulative preferred stock, and \$35,000,000 principal amount of Associated Gas and Electric Company 5% convertible certificates, together carried at	43, 917, 994
\$200,000 principal amount of Cities Service Company 6% notes due 1932, carried at	200, 000
\$2,000,000 principal amount of Utilities Power & Light Corporation 5% debentures due 1959, carried at	1, 916, 250
Total	78, 679, 056

<sup>536</sup> Op. cit. supra, note 46, pp. 1355-6 and op. cit. supra, note 6, Commission's Exhibit No. 3771, Part VII, Table 33.

<sup>537</sup> Id., Exhibit H to Mr. Sux's testimony.

<sup>538</sup> Id., at 27076.

<sup>539</sup> This was from July 1926 to August 1927 when its portfolio was a due bill for 242,700 shares of Associated Gas and Electric Company \$7 preferred stock. (See supra, p. 646.)

<sup>540</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3772, Item 12.

<sup>541</sup> The portfolio of this company consisted largely of securities of Associated Gas and Electric Company.

As a result of the September 30, 1931, exchange, the carrying value of investments in Associated Gas and Electric Company preferred stock or obligations convertible by Associated Gas and Electric Company into its preferred stock increased to \$56,743,933. Mr. Stix selected most of this large block of Associated Gas and Electric Company securities for Eastern Utilities Investing Corporation's portfolio at a time when he was recommending that all companies in the Associated Gas & Electric System immediately discontinue dividend payments.<sup>542</sup> Associated Gas and Electric Company did discontinue dividends on its preferred stocks after April 1932.<sup>543</sup>

The officers of Eastern Utilities Investing Corporation certified to the debenture trustee under date of October 9, 1931, that as of September 30, 1931, the fair value of the corporation's total assets was \$52,624,807.91.<sup>544</sup> The market value of the company's portfolio securities as computed for the purpose of justifying this certificate aggregated between \$52,378,734.50 and \$51,901,121.50 according to an exhibit offered in evidence by a representative of the "System."<sup>545</sup> This aggregate valuation included a valuation of \$24,500,000 assigned to the \$35,000,000 principal amount of Associated Gas and Electric Company convertible certificates—a valuation based merely on one bid of 70. But according to a schedule prepared in the office of Harris, Forbes & Company, the estimated value of the same portfolio, as of only fifteen days later, was only \$33,710,892.<sup>546</sup> On the basis of this valuation of \$33,710,892, the market value of Eastern Utilities Investing Corporation's portfolio was only about 96% of the face amount of its outstanding debentures,<sup>547</sup> whereas in the indenture covering this debenture issue the company had covenanted to maintain an asset ratio of 125% of the amount of outstanding debentures at all times, and not to pay any dividends while this asset ratio was below 150%.<sup>548</sup> Even the much higher valuation of \$52,624,807.91 certified by the company's own officers gave an asset ratio of only 150.4%, or a small fraction over the required 150%, indicating that the values were assigned to permit continuation of dividends.

According to the valuation in the bankers' files, the Eastern Utilities Investing Corporation debentures should then have been considered in default. However, no default was publicly declared or admitted then or at any time thereafter.<sup>549</sup>

<sup>542</sup> *Op. cit. supra*, note 6, at 25211.

<sup>543</sup> *Id.*, Exhibit F to Mr. Stix's testimony. The dividends resumed in 1935 were merely scrip. (See also *id.*, at 26972 et seq., and Commission's Exhibit No. 3775.)

<sup>544</sup> *Id.*, Commission's Exhibit No. 3782, Item 28.

<sup>545</sup> *Id.*, Exhibit A to Mr. Cromwell's testimony.

<sup>546</sup> *Id.*, Commission's Exhibit No. 3842, Item 39.

<sup>547</sup> *Ibid.*

<sup>548</sup> *Id.*, Commission's Exhibit No. 3771, Part I.

<sup>549</sup> As will be discussed in more detail hereafter, as late as May 12, 1933, the Eastern Utilities Investing Corporation wrote its debenture holders (*id.*, Commission's Exhibit No. 3772, Item 39): "The Indenture under which your Debentures were issued provides, among other things, that so long as any Debentures are outstanding, the fair value of the assets of this Corporation shall be equal to at least 125% of the aggregate amount of all its indebtedness; also that any deficiency under such provision, continued for sixty days after notice to this Corporation from the Trustee, shall constitute a default. The unprecedented decline in security values has made it apparent that a material upturn in quoted values would be necessary to avoid such a default. Dividends on this Corporation's preferred stocks were discontinued some time ago." This letter was written although the ratio of market value of its portfolio to its funded indebtedness, according to the company, was then only 8½%. (*Ibid.*)

## 4. EXCHANGE OFFER OF SEPTEMBER 1931

On September 28, 1931, Associated Gas and Electric Securities Company, Inc., made a new offer of exchange for the remaining Eastern Utilities Investing Corporation debentures outstanding with the public. It offered to exchange either \$1,000 principal amount of Associated Gas and Electric Company 5% Convertible certificates<sup>550</sup> or \$900 principal amount of Associated Gas and Electric Company Gold Debentures, Consolidated Refunding 4½% Series due 1958 for \$1,000 principal amount of debentures of Eastern Utilities Investing Corporation. This letter of September 28, 1931, sent by Associated Gas and Electric Securities Company, Inc., to the holders of Eastern Utilities Investing Corporation 5% Gold Debentures due 1954, also stated:<sup>551</sup>

The additional \$100 principal amount of Associated Gas and Electric Company 4½ Gold Debentures, due 1958, necessary to round out the amount deliverable to an even \$1,000 principal amount will be sold to the [debenture holders] at the closing market price on the date of deposit of the Eastern Utilities Investing Corporation debentures, if so desired.

In order to avoid any misunderstanding please note that the enclosed form of letter of transmittal, which is for your convenience in depositing your debentures, contains a provision whereby you agree to hold the Associated Gas and Electric Company securities received in exchange for a period of at least 120 days from the date of delivery thereof.

That offer was made subject to withdrawal at any time without notice. The time of termination of the offer was fixed at November 30, 1931.<sup>552</sup> The terms of the offer were such that one wishing around \$1,000 of Associated Gas and Electric Company debentures would have to invest an additional \$100 cash in that company. The letter said that the enclosed form of letter of transmittal was for the investor's convenience in depositing his debentures, but the form letter of transmittal contained a provision prohibiting the holder from disposing, for at least 120 days, of the Associated Gas and Electric Company securities received in exchange, thereby avoiding any pressure on the market such sales might cause.

The New York Trust Company, trustee of the Eastern Utilities Investing Corporation debenture issue, while these offers of exchange were being made, was repeatedly requested by debenture holders for information regarding the value of the portfolio, but referred such inquiries to the issuing corporation, which was controlled by the "System" making the offers.

Mr. Cooper testified:<sup>553</sup>

Q. In other words, there was some doubt about the Eastern Utilities Investing Corporation portfolio, and when that doubt was raised, the trustee still did nothing further than refer the inquirer to the issuing corporation?

A. That is correct.

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<sup>550</sup> Id., at 26998. As of two days later \$35,000,000 principal amount of these were put into Eastern Utilities Investing Corporation's portfolio apparently at 70. (See *supra*, pp. 722-3.) Mr. Stix testified they were worth 50.

<sup>551</sup> Id., Commission's Exhibit No. 3772, Item 39.

<sup>552</sup> Ibid.

<sup>553</sup> Id., at 23775-6.

The trustee was put on notice in September 1931 by The Fulton County National Bank and Trust Company that the debentures of Eastern Utilities Investing Corporation were selling at around 36.

Mr. Cooper testified:<sup>554</sup>

Q. So that The New York Trust Company on or about September 1931 was put on notice that the Eastern Utilities Investing Corporation debentures were selling around 36?

A. Yes.

Considering the fact that under the terms of the indenture Eastern Utilities Investing Corporation was obligated to maintain a ratio of assets to debentures of 125% at all times and of 150% so long as dividends were declared, the market price of \$36 for the debentures would indicate either a lack of such coverage or a market completely out of line with the assets of the company. In either event, the trustee might have been expected to fortify itself with information upon the condition of the company in order to act under the indenture, if the required asset coverage did not exist, so as to protect the debenture holders from suffering further losses. However, the debenture trustee contented itself with asking for an interim certificate of asset value,<sup>555</sup> and when officers of Eastern Utilities Investing Corporation filed a certificate, in the form called for by the indenture, showing a barely adequate aggregate figure, the trustee did not seek a list of the portfolio in order to check the valuation, but relied on the certificate.<sup>556</sup>

Mr. Stix testified on direct examination by his company's counsel in the Tax Proceedings as follows:<sup>557</sup>

Q. Was there any danger as of the 1st of December 1931, let us say, that there might be any default under the provisions of the indenture?

\* \* \* \* \*

A. Well, being in a declining market condition at that time we could only make surmises as to what was likely to happen. There didn't seem to be any reason that could be seen that the markets would stop declining. On the other hand, we weren't certain that they would continue to decline, and in the exercise of good, prudent, business judgment we began to give consideration to taking whatever steps should be taken to guard against the possibility of a further decline which might result in a violation of the covenants of the indenture.

Q. And you were concerned at that time with the danger of a default under the provisions of the indenture?

A. We were primarily concerned with the possibilities of a default if the decline in the market continued.

Q. Did you discuss those fears with any members of the board of directors of Eastern Utilities Investing Corporation or of any of its executive officers?

A. Yes; I did.

Q. Could you state when you first expressed those fears to them?

A. My recollection is that it was some time in late September 1931 or early part of October 1931.

<sup>554</sup> Id., at 23747.

<sup>555</sup> Id., at 23770-1.

<sup>556</sup> Id., at 23778-80. About that time the Board of Eastern Utilities Investing Corporation resolved not to make the portfolio public except to directors. See supra.

<sup>557</sup> Op. cit. supra, note 41, pp. 125, 127-134.

Q. With whom did you discuss your fears as to the danger of a default?

A. I talked to Mr. Hopson and Mr. Daly primarily.

Q. Were they directors of Eastern Utilities Investing Corporation?

A. They were.

Q. At that time?

A. Yes.

Q. Did you talk to them more than once about that?

A. Oh, yes; we had a number of discussions about it.

Q. Did they make any statements to you in reference to their reaction to those fears that you expressed?

A. Well, they were not quite as pessimistic as I was, but they felt that it was wise to take whatever steps could be devised in order to avoid the danger that might come about if the markets continued to decline.

Q. Did they make any specific request of you to work out a plan whereby you might prevent a default or eliminate the danger of a default?

A. No. As a general rule, I brought suggestions to them.

Q. Did you suggest any means or plan to prevent a default?

A. I did.

Q. At this time, in 1931, in September or December?

A. I did.

Q. Could you state whether your suggestions were ever acted upon?

A. You mean the particular suggestions in connection with this matter?

Q. Yes.

A. They were.

Q. Could you state in general what the terms of the plan were that you devised and which you suggested to the directors of Eastern Utilities Investing Corporation to prevent this default?

A. Yes. The plan was to recognize the fact that there was no way to increase the amount of assets that were in the portfolio of Eastern Utilities Investing Corporation; there was no way to arrest the decline in market values if the markets continued to decline; and therefore, the only other possible solution was to decrease the amount of outstanding indebtedness in a greater ratio than a decrease in the assets, in order to retire that indebtedness.

Q. In devising this plan did you have occasion to refer to the provisions of the indenture to see whether or not that plan would be in conformance with that indenture?

A. Yes; I did.

Q. Did you advise the directors that you could work out a plan that would be in conformance with the provisions of the indenture?

A. Yes; with the assistance of counsel.

Q. Do you know whether that plan was acted upon?

A. It was.

\* \* \* \* \*

Q. Would you state again more specifically, Mr. Stix, what that plan would provide for as you had devised it?

A. In its inception the plan provided that Associated Utilities Investing Corporation,<sup>558</sup> the holder of a very substantial block of Eastern Utilities Investing Corporation debentures, would transfer their holdings back to Eastern Utilities Investing Corporation for part of the assets that lie in the portfolio of Eastern Utilities Investing Corporation. Upon giving the matter further study, we came to the conclusion—and when I say we, I mean counsel and members of the board of directors and officers of the Eastern Utilities Investing Corpora-

<sup>558</sup> A subsidiary of Associated Gas and Electric Company.

tion and Associated Utilities Investing Corporation—that it would not be fair to the public holders of Eastern Utilities Investing Corporation debentures if they were not given an opportunity similar to that which was discussed for Associated Utilities Investing Corporation. Now it was contemplated that the debentures owned by Associated Utilities Investing Corporation would be turned over to Eastern Utilities Investing Corporation on some basis, and in view of the fact that Associated Utilities Investing Corporation had approximately \$18,000,000 principal amount of the Eastern Utilities Investing Corporation debentures, we thought that would be enough to insure the ratio of assets to indebtedness, even though nobody else tendered their bonds or offered their bonds on a similar basis for some time to come, although we could not tell how long, because we could not tell how much further the market might go down.

\* \* \* \* \*

Q. Does that resolution [at a meeting of the executive committee of Eastern Utilities Investing Corporation held on December 9, 1931] disclose whether or not any action was taken by the executive committee on the suggestions to prevent default to which you just a moment ago testified?

A. It does.

Q. Will you state what action was taken?

A. The directors approved a draft of letter that had been prepared, addressed to the holders of the five percent debentures, offering them the opportunity to surrender their debentures in exchange for securities held in the portfolio of Eastern Utilities Investing Corporation.

Mr. Stix's plan was to shrink the company's debt faster than the market decline shrank its assets. The plan did not contemplate liquidation of the portfolio in anticipation of a falling market. Apparently the relationship of Eastern Utilities Investing Corporation to the Associated Gas and Electric Company and the fact that Eastern Utilities Investing Corporation held in its portfolio large blocks of Associated Gas and Electric Company securities precluded the liquidation of those securities because of the possible effect of such liquidation upon the market price of Associated Gas and Electric Company's securities.

#### 5. EXCHANGE OFFER OF DECEMBER 1931 BY WHICH DEBENTURE HOLDERS WERE TO BID AGAINST EACH OTHER AND THE ASSOCIATED SYSTEM FOR PORTIONS OF PORTFOLIO

In order to carry out Mr. Stix's plan, the exchange offer of December 11, 1931, was made. Eastern Utilities Investing Corporation was caused to offer portions of its portfolio to those debenture holders who offered to pay, in debentures, the highest prices for these portfolio securities.<sup>559</sup> On December 11, 1931, when Associated Gas and Electric Company, through Associated Utilities Investing Corporation, held about \$18,000,000 principal amount of Eastern Utilities Investing Corporation debentures,<sup>560</sup> the debenture holders were solicited by Eastern Utilities Investing Corporation to tender their

<sup>559</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3772, Item 39.

<sup>560</sup> Id., at 25991.



debentures, until December 24, 1931, in exchange for either of the following securities contained in the portfolio of the corporation:

Associated Gas and Electric Company 5% Convertible Certificates.<sup>561</sup>

Utilities Power & Light Corporation 5% Gold Debentures, due 1959.

For the purpose of fixing the exchange prices, these portfolio securities were "to be taken at the arbitrary figure of 100" and the debenture holders were asked to state the price at which they would surrender their Eastern Utilities Investing Corporation debentures in exchange. The corporation would then accept or reject the offer. The invitation to tender stated: <sup>562</sup>

Only a limited amount of one <sup>563</sup> of the above listed issues is available to fill tenders. It is suggested, therefore, that holders indicate a second choice of the securities offered in the event the full amount of securities available for their first choice is taken by lower tenders. Tenders are on a price basis acceptable to the corporation, and will have precedence according to the priority of postmarks thereon.

By this offer, Eastern Utilities Investing Corporation placed on the debenture holders the burden of guessing the value of their debentures as compared with the value of the particular portfolio securities which Eastern Utilities Investing Corporation was offering in exchange.<sup>564</sup> Associated Gas and Electric Company did not make public what was in the portfolio,<sup>565</sup> nor the terms on which it was exchanging the Eastern Utilities Investing Corporation debentures which it held,<sup>566</sup> nor the size of its large holdings of these debentures through Associated Utilities Investing Corporation, nor that this offer was primarily an effort to give legal sanction to reacquisition by Eastern Utilities Investing Corporation of those holdings.

Mr. Hopson gave his personal attention to this exchange offer of December 11, 1931.<sup>567</sup> Halsey, Stuart & Co., Inc., took the position that Mr. Hopson was not presenting the offer fairly to the debenture holders who were being asked to bid against each other, and advised its customers not to make the exchange.<sup>568</sup> Halsey, Stuart & Co., Inc. requested from Mr. Hopson, but did not obtain, a list of the securities in Eastern Utilities Investing Corporation after September 30, 1931. An inter-office communication of Halsey, Stuart & Co., Inc., reads in part as follows: <sup>569</sup>

Unable to change his [Hopson's] ideas about latest exchange offer to Eastern Utilities Investing Corporation holders Hopson is opposed to showing in

<sup>561</sup> The same certificates which the "System" placed in the portfolio as of September 30, 1931; see *supra*, p. 728.

<sup>562</sup> *Op. cit. supra*, note 6, Commission's Exhibit No. 3772, Item 39.

<sup>563</sup> Though the letter did not state which security was limited in amount, only \$2,000,000 principal amount of Utilities Power & Light debentures was in the portfolio as compared with \$35,000,000 principal amount of Associated Gas and Electric Company convertible certificates. (*Op. cit. supra*, note 6, Commission's Exhibit No. 3774, Part VII, Tables 32 and 33.) Consequently, the reference to a limited amount of one of the two securities offered must have referred to the Utilities Power & Light debentures. Of the \$2,000,000 principal amount of Utilities Power & Light debentures available, Associated Utilities Investing Corporation obtained \$1,885,000 (*id.*, Commission's Exhibit No. 3772, Item 19).

<sup>564</sup> *Id.*, at 25989.

<sup>565</sup> Except that it included "amounts" of the securities offered. See *supra*.

<sup>566</sup> *Op. cit. supra*, note 6, at 25992-3.

<sup>567</sup> *Id.*, at 25996.

<sup>568</sup> *Id.*, at 25989-90.

<sup>569</sup> *Id.*, Commission's Exhibit No. 3843, Item 37.

advance, complete portfolio or summary. Reason, public disclosure will invite nuisance litigation. Hopson refuses allow Associated Gas and Electric Company to declare itself in advance the basis that it will exchange its holdings of Eastern Utilities Investing Corporation debentures for the convertible certificates or other collateral. \* \* \* Chase H. F. [Harris, Forbes] will not recommend Exchange for Associated Gas and Electric Company convertible certificates. \* \* \*

Satisfied nothing to gain by further discussion with Hopson and doubt if the public will let exchange many of their debentures. \* \* \*

Mr. Stuart of Halsey, Stuart & Co., Inc., replied:<sup>570</sup>

Think our only course is to insert bulletin notice that we favor ignoring the exchange offer due to the fact that the company will not disclose its portfolio and that the biggest holder, the Associated Company, refuses to state at what price it is going to turn its debentures in and what it will take in exchange.<sup>571</sup> \* \* \* We are only concerned with the fact that Hopson is not presenting the matter fairly to the Eastern Utilities Investing Corporation debenture holders. Stuart.

As a result of the exchange offers of June and September, 1931, and perhaps also as a result of Mr. Hopson's commitment to buy Eastern Utilities Investing Corporation debentures from the bankers, Associated Utilities Investing Corporation had by December 1931, acquired \$18,354,000 principal amount of these debentures.<sup>572</sup> Associated Utilities Investing Corporation tendered all these debentures to Eastern Utilities Investing Corporation pursuant to the offer of December 11, 1931 of Eastern Utilities Investing Corporation. The public response to the offer had been negligible.<sup>573</sup>

Counsel had advised the management that Eastern Utilities Investing Corporation could not acquire these \$18,354,000 of debentures from Associated Utilities Investing Corporation without making a similar offer to the public debenture holders.<sup>574</sup> This offer to exchange the portfolio securities of Eastern Utilities Investing Corporation for its debentures was a device whereby Eastern Utilities Investing Corporation could be caused to reacquire its debentures from the "System" at a price higher than that paid to the public, although the offer on its face was the same to the public as to the insiders.<sup>575</sup>

<sup>570</sup> Id., Commission's Exhibit No. 3843, Item 39.

<sup>571</sup> Mr. Stix testified (id., at 25992-3) :

Q. Did Associated Gas and Electric Company make public the terms on which it was going to exchange its holdings of Eastern Utilities Investing Corporation's debentures?

A. I don't recall that they did.

Q. As a matter of fact, you are pretty sure that they did not? Is that right?

A. I would be inclined to think that they did not; yes.

<sup>572</sup> Id., Commission's Exhibit No. 3772, Item 19.

<sup>573</sup> Ibid. and id., at 25993-4.

<sup>574</sup> Op. cit. supra, note 41, p. 132.

<sup>575</sup> The witness claimed that Associated Gas and Electric Company did not accept this offer of exchange made by Eastern Utilities Investing Corporation on December 11, 1931, but made another deal for the same securities. (Op. cit. supra, note 6, at 25992.) Mr. Stix testified (id., at 25991) :

Q. Did Associated Gas and Electric Company make a tender of its debentures to Eastern Utilities Investing Corporation?

A. Well, I don't know whether it was exactly a tender, but there was a transaction which took place in the fall of 1931, which was dropped on the receipt by Associated of some \$18,000,000 convertible obligations, and the acquisition by Eastern Utilities Investing Corporation of notes and common stock of a company which was then a subsidiary of Associated, but after the transaction was consummated became a subsidiary of Eastern Utilities Investing Corporation.

See also op. cit. supra, note 46, pp. 2183-4.

When tendering their debentures, the debenture holders were to state the prices at which they would tender their Eastern Utilities Investing Corporation debentures for these portfolio securities, which for the purpose of the tender were to be taken at the arbitrary figure of \$100, that is, at par.<sup>576</sup> The proposal that tenders be made on such a basis was designed so that on its face all debenture holders had the same opportunity. However, the public holders were, in effect, to compete against each other and against Associated Utilities Investing Corporation with respect to the amount of portfolio securities they would receive for each Eastern Utilities Investing Corporation debenture. It will be recalled that Associated Utilities Investing Corporation was a "System" company. Its board of directors consisted of the same individuals as those who were on the board of Eastern Utilities Investing Corporation and it knew the prices at which the public tendered before it made its tender.<sup>577</sup> On the basis of the tenders which were accepted, the public debenture holders received a maximum of \$98.10, principal amount of Utilities Power & Light Corporation debentures for each \$100, principal amount of Eastern Utilities Investing Corporation debentures tendered for that issue,<sup>578</sup> and not more than \$100, principal amount of Associated Gas and Electric Company convertible certificates for each \$100, principal amount of Eastern Utilities Investing Corporation debentures tendered for that issue;<sup>579</sup> whereas Associated Utilities Investing Corporation took \$98.87 in Utilities Power & Light Corporation debentures<sup>580</sup> and \$103 in Associated Gas and Electric Company convertible certificates.<sup>581</sup> The tender by Associated Utilities Investing Corporation was the highest tender accepted.<sup>582</sup>

Of course, had Eastern Utilities Investing Corporation been liquidated and a distribution of the portfolio in kind made to its security holders, the debenture holders would have had first priority with respect to the entire portfolio and would have had the right to receive for their holdings up to \$1,000 in value of securities in the portfolio for each \$1,000 face amount of debentures held. Under such a procedure, the debenture holders would have received more than was offered them by this exchange.<sup>583</sup>

<sup>576</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3772, Item 39.

<sup>577</sup> Ibid. and op. cit. supra, note 6, at 2225-8.

<sup>578</sup> The market price of these Utilities Power & Light debentures in December 1931 was high 54, low 36½ last 44½.

<sup>579</sup> Id., Commission's Exhibit No. 3822. These convertible certificates were valued around 50. (See supra.)

<sup>580</sup> Op. cit. supra, note 46, at 2163, 2220-1.

<sup>581</sup> \$103 was the call price and the maximum allowable under the offer.

<sup>582</sup> Op. cit. supra, note 46, at 2157-8. Also see letter to public debenture holders stating that "tenders are being received between 40 and 60" (id., Commission's Exhibit No. 3822; letter dated December 19, 1931, to Emery, Peck & Rockwood Co. in reply to a letter from them dated December 16, 1931; also letter dated December 22, 1931, to Edward S. Preston in reply to letter dated December 18, 1931). Actually, no tenders at such low figures had been received. (Op. cit. supra, note 46, at 2123, 2126, 2151-5, 2165, 2221-6. Op. cit. supra, note 6, Commission's Exhibit No. 3822 shows no tenders below \$0.)

<sup>583</sup> See note 579, supra. Mr. Cooper testified (id., at 23835-6) :

Q. As a matter of fact, you were aware that the Eastern Utilities Investing Corporation debentures were selling at a low market price, were you not?

A. I believe so.

Q. And that the Associated System or one of its companies had been exchanging "System" securities for the debentures, isn't that right?

A. That is correct.

Q. And you, therefore, assumed that the securities offered in exchange were worth not very much more in any event than the market price of the debentures at that time?

A. That is correct.

### a. The Reacquired Debentures Were Not Immediately Retired

By the December 1931 exchange offer described above, Eastern Utilities Investing Corporation reacquired from the "System" \$18,354,000 principal amount of its debentures, delivering in exchange \$1,885,000 principal amount of Utilities Power & Light debentures and \$16,942,000 of Associated Gas and Electric Company convertible certificates.<sup>584</sup>

But these \$18,354,000 principal amount of Eastern Utilities Investing Corporation debentures which Associated Utilities Investing Corporation, an Associated Gas and Electric Company subsidiary, had acquired from the public and tendered, pursuant to the exchange offer in December 1931, to Eastern Utilities Investing Corporation, were not physically transferred to Eastern Utilities Investing Corporation. An inactive company was taken from the "grave yard"<sup>585</sup> and made a subsidiary of Eastern Utilities Investing Corporation.<sup>586</sup> Mr. Stix directed that the \$18,354,000 of debentures be transferred to that subsidiary, which later became known as Southern Utilities General Corporation.<sup>587</sup> Then, on April 12, 1932, Utility Accountants and Tax Consultants<sup>588</sup> issued a certificate stating that, as of December 31, 1931, Eastern Utilities Investing Corporation had outstanding only \$16,506,000 principal amount of debentures.<sup>589</sup> Based on this alleged amount of debt, the ratio of the assigned value of the assets of Eastern Utilities Investing Corporation to its debt would be more than the 150% required by the indenture as a condition precedent to the declaration of dividends.<sup>590</sup> The transaction to achieve this objective had to be consummated before the year end so that the certificate of debt might reflect the ostensible compliance with the indenture provision, and the letters of acceptance were dated December 30 and 31, 1931.<sup>591</sup> In January 1932, dividends were declared payable in the spring of 1932 and paid primarily to the "System," which held most of the preferred.<sup>592</sup>

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<sup>584</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3772, Item 19. These convertible certificates had been placed in Eastern Utilities Investing Corporation's portfolio as of September 30, 1931, in exchange for other securities, at a price of 70; but were worth only about 50. (See supra, pp. 722-4, *Portfolio Switch of September 30, 1931.*)

<sup>585</sup> Op. cit. supra, note 41, p. 237.

<sup>586</sup> Id., at 238. In said tax case, one of the issues involved the question whether this company, Southern Utilities General Corporation, was actually made a subsidiary of Eastern Utilities Investing Corporation before or after it acquired legal title to the \$18,354,000 of Eastern Utilities Investing Corporation debentures.

<sup>587</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3772, Item 28.

<sup>588</sup> A service company sponsored by H. C. Hopson. See Appendix G, pp. 790-8.

<sup>589</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3782, Item 42.

<sup>590</sup> Id., at 23806-8.

<sup>591</sup> Op. cit. supra, note 41, pp. 152, 241-2.

<sup>592</sup> Op. cit. supra, note 6, at 23842-3; and see supra.

However, on the records of The New York Trust Company, trustee under the Eastern Utilities Investing Corporation indenture, \$35,000,000 of debentures were listed as still outstanding.<sup>593</sup>

The purpose of arranging the transaction so that the Trustee's records still showed \$35,000,000 principal amount of Eastern Utilities Investing Corporation debentures outstanding was to make necessary the concurrence of holders of at least 15% of the full \$35,000,000 principal amount in order to require the debenture trustee, The New York Trust Company, to act under the terms of the indenture. And the purpose of arranging the transaction so that a subsidiary of Eastern Utilities Investing Corporation held \$18,494,000 principal amount of Eastern Utilities Investing Corporation debentures was to enable the management to certify that only \$16,506,000 principal amount were outstanding and that the asset coverage requirements were satisfied thereby to avert a default. The management claimed that outstanding debentures were \$35,000,000 for one purpose and \$16,506,000 for another.<sup>594</sup>

Mr. Stix, when examined by his own counsel, testified as follows:<sup>595</sup>

Q. I believe you stated yesterday in your testimony, Mr. Stix, that in the late part of the year 1931, when the market prices of securities generally were falling, that you had given consideration to a plan whereby you could eliminate and reduce the danger of a default under the indenture provisions of the Eastern Utilities Investing Corporation debentures, and that you devised a plan whereby you could reduce the indebtedness of Eastern Utilities Investing Corporation by offering to the public holders of debentures and to others who held Eastern Utilities Investing Corporation debentures that they could exchange their debentures in Eastern Utilities Investing Corporation for certain portfolio securities of Eastern Utilities Investing Corporation: is that right?

A. That is correct.

Q. Now, were you familiar with the provisions of the indenture which provided for remedies given to minority bondholders?

A. I was.

Q. In formulating your plan, did you give consideration at all to those provisions?

A. I did.

Q. As a result of that consideration, what did you determine to do?

A. Well, you really have to outline the whole plan to get a proper understanding of how each of these covenants and restrictions affected just what took place. In the first instance, the problem was to make certain that, irrespective of how far

<sup>593</sup> Id., at 23801. Mr. Stix testified before a Special Master in a proceeding by the Bureau of Internal Revenue involving a tax matter of the "System" that the transaction was handled in this manner in order to require the demand of 15% of the full \$35,000,000 principal amount of debentures to force the trustee to act under the indenture and yet to enable the accountants to compute asset coverage on the theory that there were only \$16,506,000 principal amount of debentures outstanding. (Op. cit. supra, note 41, pp. 456-8.) In that proceeding it was important for the management of the "System" to prove that the transaction was not made for tax purposes, whereas Mr. Stix testified at an examination before the Securities and Exchange Commission that the transaction was in fact made for tax purposes as well (op. cit. supra, note 6, at 26030):

Q. Do you know why the Eastern Utilities Investing Corporation debentures were put into a subsidiary of Eastern Utilities Investing Corporation rather than being turned over to Eastern Utilities Investing Corporation for cancellation?

A. I think there were two reasons: one had to do with the question of how many bonds would be outstanding under the indenture, and I believe that later turned out to have no basis at all. The other was for tax purposes.

<sup>594</sup> See infra.

<sup>595</sup> Op. cit. supra, note 41, pp. 233-238, 240-241.

the market declined, within reasonable limits, proper safeguards were placed around Eastern Utilities Investing Corporation so that its portfolio value would conform to the provisions in the indenture; specifically, the 150% as to dividends.

Then there was another covenant in the indenture with respect to maintenance of 125% of assets against outstanding indebtedness also, which had nothing to do with the question of declarations of dividends.

Now, as to those, the plan was to offer assets of Eastern Utilities Investing Corporation in exchange for outstanding Eastern Utilities Investing Corporation debentures.

There was another provision in the indenture that had to do with action by the Trustee upon the request of fifteen percent of the outstanding bonds. The indenture provisions with respect to the fifteen percent of outstanding bonds was not clear with respect to what it meant by "outstanding bonds." At least it didn't have a definition in that particular section or article describing precisely what was meant by "outstanding bonds."

There was a definition in the indenture in the sections which had to do with 150% and 125%, which defined outstanding bonds, and my understanding of those definitions was that as to the 125% and 150% covenants it applied to outstanding bonds which were not held in the treasury of Eastern Utilities Investing Corporation or in the treasury of a subsidiary company of Eastern Utilities Investing Corporation.

As to the fifteen percent provision which had to do with action on the part of the trustee when requested by fifteen percent of the bondholders, there was no such definition, and therefore there was a question as to whether or not fifteen percent meant fifteen percent of the thirty-five million which the Trustee had authenticated or whether it meant fifteen percent of the bonds outstanding either on the books of Eastern Utilities Investing Corporation, if that happened to be less than thirty-five million, or on a consolidated basis of Eastern Utilities Investing Corporation and a subsidiary.

We took the position that in the absence of a definition we could seriously contend the fifteen percent applied to the thirty-five million that the Trustee had authenticated.

Having in mind the possibility that on a declining market with the debentures selling fairly low it might be possible for hostile interests or hostile people—"sharpshooters," as we call them sometimes—to either acquire enough bonds or induce the holders of bonds to enter into an agreement to ask the Trustee to take action under the indenture if the market declined further and we had very serious financial conditions. We reasoned that it would be more difficult for an individual or group of individuals to gather together fifteen percent of thirty-five million than it would to gather together fifteen percent of sixteen million, so that if our contention was right that fifteen percent of thirty-five million was required for the Trustee to take action we could delay any action until this group of bondholders had gathered together fifteen percent of thirty-five million; and, at any rate, it gave us what we thought was an opportunity to raise that particular question and have it adjudicated; and if we were right, we were so much better off, and if we were wrong we didn't lose anything in the process.

Now, in order to preserve that particular advantage of having the possibility of making bondholders get together fifteen percent of thirty-five million, it was decided that the bonds themselves should not be placed on the books of Eastern Utilities Investing Corporation at all; and when the tenders were finally announced and Mr. Day and Mr. Shehan, who were running the books of Eastern Utilities Investing Corporation at that time, began to make the entries in connection with those transactions I called them into my office—I

am not sure that I called in both of them. I called in either one or the other. I told them to go into what we called the "graveyard" and find a corporation which was in existence but which had not yet been used for any purpose whatsoever, so that its history would be clean, and make it a subsidiary of Eastern Utilities Investing Corporation and to handle the tenders and the exchanges which resulted from the tenders through the accounts of that particular company.

Now, I didn't suggest to them that they select Southern Utilities General Corporation, because I wasn't specific as to what company they selected, so long as they selected a company which had no previous history. Southern Utilities General was the one that they selected. Whether they had a reason for that or not, I don't know. I don't believe they had any particular reason, except that it was one of the companies that had no back history. They were to make that a subsidiary of Eastern Utilities Investing Corporation before the transactions with respect to exchange of securities were recorded, and it is my understanding that that is what they did.

\* \* \* \* \*

Q. Did you direct your subordinates to see that the stock of that company was transferred to the investment account of Eastern Utilities Investing Corporation prior to making the exchange?

A. Well, in outlining the plan in the first instance that was the premise I started on, that they would find such a corporation and make it a subsidiary of Eastern Utilities Investing Corporation before they handled the transactions with respect to the exchanges. The sole purpose being to straddle these two provisions in the indenture, or three provisions in the indenture. They really divided this into two parts. Now I may have given the impression in the testimony that I devised this all by myself, but I do not intend to. This is the result of conferences and discussions and finally this scheme evolved. Whether it came out of my own particular head or came as the result of conferences and discussions, I can not state right now. I think some of it came out of my head. But all these ideas were talked over back and forth and finally perfected.<sup>596</sup>

This plan to obstruct the debenture holders' right to call on the debenture trustee to enforce their rights assumes that the trustee would not act on its own initiative contrary to the desires of the management of the company. The management took this position to prevent operation of the protective provisions in the indenture which had been inserted ostensibly for the benefit of all the debenture holders to whom the management owed an obligation.

## 6. EXCHANGE OFFER OF MAY 1932

On May 21, 1932, Chase Harris Forbes Corporation, bankers connected with the original sale of the debentures, by letter to debenture holders called attention to the current offer made by Associated Gas and Electric Securities Company, Inc., to exchange the debentures of Eastern Utilities Investing Corporation on a par-for-par basis for Associated Gas and Electric Company Gold Debenture Bonds,

<sup>596</sup> Mr. Stix enumerated the individuals who formulated the aforementioned plan as follows (id., at 230): "Yes; well, it is a habit of mine. Talking of we, I speak of the individuals who were primarily responsible for the financial policies of the Associated System and counsel that are associated with them. Primarily, Mr. Hopson, Mr. Daly, Mr. Travis, and his associates, plus such subordinates of mine that I might give directions to in carrying out these instructions. Does that define it sufficiently for you?"



Consolidated Refunding 4½% Series, due 1958. They wrote that they believed the offer was entirely fair because the income of Eastern Utilities Investing Corporation was largely dependent on income from stocks and convertible obligations of Associated Gas and Electric Company. These were securities which Associated Gas and Electric Company had caused Eastern Utilities Investing Corporation to acquire without objection from the bankers. The bankers were represented on the Board.<sup>597</sup> That letter stated:<sup>598</sup>

We feel that this offer should be brought to the attention of all holders of the debentures as it affords direct improvement in security position without cash consideration and only a slight reduction in annual income. As indicated by the corporation's annual report, the income of Eastern Utilities Investing Corporation is largely dependent upon dividends and interest received on preferred stocks and obligations (convertible at the option of the company) of Associated Gas and Electric Company.<sup>599</sup> In view of these facts we believe that the offer is entirely fair and should receive the consideration of all debenture holders.

The offer to make such exchange, which was advertised in the newspapers by public notice, terminated May 25, 1932. The same offer was publicized in the newspapers by Associated Gas and Electric Securities Company, Inc., with the termination date fixed at June 15, 1932, and a later offer with the same terms expiring June 25, 1932, was similarly publicized.<sup>600</sup>

## 7. THE INDENTURE<sup>601</sup>

### a. Its Preparation

The indenture for the \$35,000,000 debenture issue of Eastern Utilities Investing Corporation offered to the public in March 1929 had been jointly prepared and revised by Sullivan and Cromwell, counsel for Harris, Forbes & Company for many years,<sup>602</sup> and by the Associated Gas & Electric System and its counsel, now known as Travis, Brownback & Paxson.<sup>603</sup> Since Harris, Forbes & Company was the originator of the underwriting, its buying department may have given greater attention to the drafting of the indenture than did Halsey, Stuart & Co., Inc.; but the buying department of Halsey, Stuart & Co., Inc., participated in the preparation of the indenture and was satisfied with its provisions.<sup>604</sup>

The trustee, The New York Trust Company, had no part in the drafting of the indenture. On March 28, 1929, after the debentures

<sup>597</sup> See *supra*.

<sup>598</sup> Op. cit. *supra*, note 6, Commission's Exhibit No. 3772, Item 39.

<sup>599</sup> See note 597.

<sup>600</sup> Op. cit. *supra*, note 6, Commission's Exhibit No. 3772, Item 39.

<sup>601</sup> Copy of the indenture is contained in *id.*, Commission's Exhibit No. 3771, Part I.

<sup>602</sup> *Id.*, at 23674 and 23488.

<sup>603</sup> Mr. Burroughs testified (*id.*, at 23502-3) :

A. It [the circular] shows that Charles M. Travis as an individual and the firm of Roberts & Montgomery acted as counsel to the company.

Q. Mr. Brownback, who is now a partner of Mr. Travis, was then a partner of Roberts & Montgomery?

A. That is correct.

Q. By the time of the January 1930 circular, company counsel was Messrs. Travis & Paxson?

A. That is correct.

See also op. cit. *supra*, note 46, p. 1718.

<sup>604</sup> Mr. Stuart testified (op. cit. *supra*, note 6, at 27301) :

Q. And you approved the indenture, did you not?

A. We approved it? Yes; I guess we did \* \* \* I would say we approved it.



had been publicly offered for sale on March 19, 1929,<sup>605</sup> a practically final draft was submitted by the issuer's counsel to the trustee and its counsel for comments in connection with its workability.<sup>606</sup>

However, the changes which they suggested were minor in character.<sup>607</sup> The trustee had limited its review of the draft to a consideration of its "workability" and to the clause exculpating the trustee from liability.<sup>608</sup>

Eastern Utilities Investing Corporation had no representation in connection with the preparation of the indenture except by the staff of the Associated System and Hopson's service organizations.<sup>609</sup>

Apparently there were no differences of opinion and no negotiations as to the provisions of the indenture. The indenture was drawn in such a manner as to give those in control of Eastern Utilities Investing Corporation the widest latitude in handling the affairs of the company and so as to impose no restrictions on dealing with the company's portfolio. The bankers claim that they considered the debentures amply secured because of the diversification of investments, yet the indenture did not contain any requirements that the portfolio be diversified. Nor did the charter or bylaws of Eastern Utilities Investing Corporation impose any diversification requirements, either as to the initial portfolio or the subsequent portfolio.<sup>610</sup> Although the Eastern Utilities Investing Corporation was completely controlled by a holding-company system, the indenture contained no prohibitions against or safeguards with respect to transactions by the company with controlling or affiliated interests: on the contrary the charter went far toward providing that the company might enter into transactions with such interests:<sup>611</sup>

In the absence of fraud, no contract or transaction between the Corporation and any other corporation, association, or firm, and no act of the Corporation, shall in any way be affected or invalidated by the fact that any of the Directors or officers of the Corporation is in anywise, pecuniarily or otherwise, interested in, or is a shareholder, director, officer, or member of, or is otherwise connected with, such other corporation, association, or firm.

<sup>605</sup> Mr. Downing, then secretary of The New York Trust Company, testified (*id.*, at 23663) :

Q. What part did The New York Trust Company take in the drafting of that [Eastern Utilities Investing Corporation] indenture?

A. They had no part, as I recall, in the drafting of it. It was submitted to them for comment for workability \* \* \*.

<sup>606</sup> Mr. Downing testified (*id.*, at 23663-6) :

Q. What was the name of counsel who reviewed the indenture on behalf of The New York Trust Company?

A. I assume it was Mr. Begg \* \* \*.

<sup>607</sup> *Id.*, Commission's Exhibit No. 3782, Item 11. Copy of letter dated March 30, 1929, from The New York Trust Company to Mr. Charles M. Travis: "\* \* \* would it not be desirable to insert in the second line of that section after the word 'any' the word 'stock'? \* \* \* It is our understanding that Mr. Begg, of Messrs. Hornblower, Miller & Garrison, will communicate with you direct respecting a few minor changes."

<sup>608</sup> Mr. Downing testified (*id.*, at 23667) :

Q. And did The New York Trust Company review the indenture from any point of view except from the practical viewpoint \* \* \*?

A. Workability viewpoint \* \* \*.

Q. How would you describe what the question of workability involves?

A. \* \* \* possibly whether or not they gave themselves time after the close of their fiscal year to give you any statements required.

<sup>609</sup> See *supra* and Appendix G, pp. 790-8.

<sup>610</sup> *Op. cit.* *supra*, note 6, Commission's Exhibit No. 3771, Part I.

<sup>611</sup> *Ibid.*

The obligation of the investment company to the debenture holders was not collateralized, for the indenture did not require the hypothecation of any stocks, bonds, or other assets with the trustee or with any other person. The debenture obligation, therefore, was admittedly<sup>612</sup> the equivalent of an unsecured promissory note.

#### b. The So-Called "Protective Provisions" of the Indenture

The indenture contained a number of provisions and conditions which, when divorced from the entire instrument superficially appeared to be protective safeguards, but which, when construed in the light of the entire instrument, depended for their efficacy solely upon the vigor with which the trustee would undertake to perform a moral rather than a legal obligation.<sup>613</sup> Since the trustee was, by the terms of this indenture, under no affirmative legal duty to perform any positive act to enforce the safeguards and protective provisions contained in the indenture until a certain percentage of the debenture holders requested such action,<sup>614</sup> mere complacency and inertia on the part of the trustee would render the seeming protection of the protective provisions of the indenture illusory, unless the debenture holders took such action. It was unlikely that they would.

As ostensible safeguards or protective provisions for the benefit of the debenture holders, the indenture provided that the company covenanted that it would not issue any indebtedness ranking prior to or on a parity with these debentures unless the value of its assets was at least 200% of its total debt after such issuance.<sup>615</sup> The indenture also provided that no cash dividends could be declared unless the value of the company's assets exceeded 150% of its funded debt.<sup>616</sup> The issuing company also covenanted at all times to maintain a ratio of assets to funded debt of at least 125%,<sup>617</sup> and that, if at any time, this ratio should fall below 125%, the trustee might take steps toward declaring the principal of the debentures and any unpaid interest thereon to be due and payable and might thereupon take steps to enforce the rights of the holders by petition for a receiver or other suit.<sup>618</sup> However, the trustee was not required to give notice to the company to remedy the default unless the holders of at least 30% of the face amount of outstanding debentures affirmatively required it to do so, nor, even if the default continued throughout the 60-day period of grace, to declare the debentures due and payable or bring suit unless required to do so by the holders of at least 15% of the debentures.<sup>619</sup>

Since these provisions depended upon the ratio of asset value to debt, the determination of the asset value and of the amount of debt was most important. The indenture did not require independent certification of asset value, but provided merely that officers of East-

<sup>612</sup> *Id.*, at 25215.

<sup>613</sup> *Id.*, at 23671-2.

<sup>614</sup> *Id.*, at 23673.

<sup>615</sup> *Id.*, Commission's Exhibit No. 3771, Part I.

<sup>616</sup> *Ibid.*

<sup>617</sup> *Ibid.*

<sup>618</sup> *Ibid.*

<sup>619</sup> *Ibid.*

ern Utilities Investing Corporation should annually file with the trustee a certificate stating the fair value of the total assets of the company.<sup>620</sup> The indenture provided that the fair value should be based upon the market value of securities dealt in on any exchange or regularly quoted in financial periodicals or, in the absence of such quotation, upon cost, unless the officers thought that the securities had a lesser fair value.<sup>621</sup>

Although this method of valuation per se may present a fair standard, it was completely circumvented and rendered meaningless by the technique employed. The officers of Eastern Utilities Investing Corporation who filed these certificates were primarily employees of H. C. Hopson and Company and later of Utility Accountants and Tax Consultants, both Hopson service companies.<sup>622</sup> The same employees had charge of keeping the books of Eastern Utilities Investing Corporation and of managing its portfolio. Their interest might, therefore, be to resolve any doubts in favor of an asset value which would be ample to satisfy the "protective provisions." In preparing these certificates, the officers used unpublished quotations and bid prices of stocks as being sufficient to establish the "fair value."<sup>623</sup> In many instances, as has been indicated, nonmarketable securities of Associated Gas and Electric Company were placed in the portfolio of Eastern Utilities Investing Corporation and these securities were assigned a value equal to their par value. However, no exception was taken to these certificates by the trustee. Furthermore, Haskins & Sells, the auditors, accepted the company's own valuation of securities in the portfolio although that accounting firm had a great deal of knowledge concerning the values of securities issued by companies in the Associated Gas & Electric System.<sup>624</sup>

The indenture made no provision for an independent certification of the amount of debt. It required that a certificate as to the amount of the company's debt be filed by a "reputable public accountant."<sup>625</sup> The construction adopted by the management and acquiesced in by the trustee was such as to permit these debt certificates to be prepared and filed by the Hopson service organizations which employed

<sup>620</sup> *Ibid.*

<sup>621</sup> *Ibid.*

<sup>622</sup> *Id.*, Commission's Exhibit No. 3782, Items 17a, 28, and 43, shows certificates of asset values filed with The New York Trust Company and signed by John M. Daly and A. E. Koch, vice president and assistant treasurer, respectively, of Eastern Utilities Investing Corporation. *Id.*, Commission's Exhibit No. 3782, Item 27, shows certificate of indebtedness filed with The New York Trust Company by H. C. Hopson and Company and also signed by John M. Daly. (See also *id.*, Items 17 and 42.) Mr. Stix testified (*id.*, at 24763) :

Q. And H. C. Hopson and Company rendered service to Eastern Utilities Investing Corporation, did it not?

A. Yes.

Q. What kind of service?

A. Well, it kept the books and the minute books; it safeguarded the securities; it bought securities and sold securities for them.

Q. It rendered all of the services, did it not, that the management of the company ordinarily renders?

A. Yes.

<sup>623</sup> *Id.*, at 24346, 24384-90.

<sup>624</sup> Haskins & Sells had received that information from their yearly audits of a great many companies in the "System," yet in preparing the report for the period ending January 31, 1929, and in determining the value of the securities in the company's portfolio at that time, they did nothing beyond stating that they could not find quotations of such "System" securities. (*Id.*, at 24357-9.)

<sup>625</sup> *Id.*, Commission's Exhibit No. 3771, Part I.

the officers filing the asset certificates.<sup>626</sup> These Hopson service companies did the day to day accounting work of Eastern Utilities Investing Corporation<sup>627</sup> and, consequently, as far as their work was concerned, they were merely an accounting department of the Associated Gas & Electric System. They did not make a practice of doing accounting work for companies which were not affiliated with the Associated Gas & Electric System.<sup>628</sup> Yet the trustee accepted these Hopson service companies as "public accountants" within the meaning of that phrase as used in the indenture. The indenture would have dispelled any doubt on this point if it had required that the certificate be filed by an independent reputable public accountant or an independent certified public accountant. However, the indenture was construed in actual operation to permit the company's officers to file both the certificate as to asset value and the certificate as to debt. Mr. Cooper, an officer of the trustee, testified:<sup>629</sup>

Q. Earlier in your testimony you said, as I recall, that public accountants were accountants who did work for others. Isn't that right?

A. Yes, sir.

Q. Did you consider that H. C. Hopson and Company was doing work for others?

A. Yes, sir.

Q. Even though H. C. Hopson and Company was doing work solely for organizations which were controlled by the persons who controlled H. C. Hopson and Company?

A. Yes, sir.

Since both the certificate as to the value of assets and the certificate as to the amount of debt were actually filed by the management, the investor substantially was in the position of a holder of an unsecured promissory note who had to rely entirely upon the good faith and judgment of the management. Moreover, the trustee was permitted by the indenture to rely on these certificates, a provision which might constitute an additional obstacle to any investor who attempted to enforce his rights.

The term "outstanding debentures" was specifically defined in the indenture.<sup>630</sup> However, this definition was made specifically applicable only to those paragraphs relating to the amount of asset coverage required. The definition was not specifically made applicable to the paragraphs dealing with the amount of debentures necessary to force action by the trustee. This loophole was later used by the management in support of its argument that the amount "outstanding" at any one moment could vary for different purposes; the amount outstanding could be considered less when computing the asset coverage of the debentures than when computing the percentage necessary to force action by the trustee.<sup>631</sup> The trustee was not required to check the correctness of the statements in the certificates filed with it unless the holders of 30 percent of the outstanding debentures directed it to do

<sup>626</sup> Id., at 23687-715 and Commission's Exhibit No. 3782, Items 17, 17a, 27, and 42.

<sup>627</sup> Id., at 24763 and see *supra*.

<sup>628</sup> Id., at 23258.

<sup>629</sup> Id., at 23703.

<sup>630</sup> Id., Commission's Exhibit No. 3771, Part I.

<sup>631</sup> *Op. cit. supra*, note 41, pp. 233-8.

so.<sup>632</sup> Similarly, although the trustee was given the right to investigate the values of the portfolio, it was not required to do so in the absence of a demand by the holders of 30% of the outstanding debentures.<sup>633</sup> Actually, it never exercised this right. The trustee was not required to recognize the existence of a default unless 15%, and in some instances 30%, of the outstanding debentures required it.

The indenture did not provide that the trustee or debenture holders should be supplied with the list of debenture holders and their addresses, which list was currently maintained by one of the "System" companies servicing Eastern Utilities Investing Corporation.<sup>634</sup> The trustee did not ask for that list, and in general took the position that it should not request information not required to be furnished under the indenture.<sup>635</sup> In view of the well-recognized fact that debenture holders, unsolicited, rarely act in concert spontaneously, the indenture created a situation where it was extremely improbable that debenture holders would ever enforce their rights. The trustee was likely to remain inactive in reliance on the indenture which permitted it to be inactive. The debenture holders could not expeditiously ascertain whether the serious impairment of the assets of their company had occurred or, even if discovered, undertake organized action with respect thereto.

Mr. Stix testified:<sup>636</sup>

Q. And wouldn't it have been much better for Eastern Utilities Investing Corporation to have issued notes that on their face were unsecured promissory notes?

A. Those were on their face unsecured promissory notes. That is all a debenture is.

Q. The debenture referred to the indenture?

A. Yes.

Q. And the indenture contained certain provisions about having so much asset coverage in order to avoid default?

A. Yes.

Q. The provisions were absolutely meaningless, were they not?

A. To my mind they meant nothing.

Q. Wouldn't it have been better not to have had any such provisions in the indenture at all?

A. I don't think they meant anything whether they were in or not.

On April 12, 1932, certificates were filed with The New York Trust Company by officers of Eastern Utilities Investing Corporation to the effect that the fair value of its assets as of December 31, 1931, had been \$27,925,331.29, and, by a Hopson service company known as Utility Accountants and Tax Consultants, that Eastern Utilities Investing Corporation had then had outstanding funded debt of only

<sup>632</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3771, Part I.

<sup>633</sup> Ibid.

<sup>634</sup> Mr. Cooper, member of the Corporate Trust Department and in charge of this indenture for the trustee, testified (id., at 23735):

Q. And the Eastern Utilities Investing Corporation could bring its list of debenture holders up to date every interest-paying date, could it not?

A. Yes, sir.

<sup>635</sup> Id., at 23821 and 23861-3. Mr. Cooper testified (id., at 23786):

Q. It [the trustee] was just remaining inactive, willing to receive any information, but did not seek anything, is that a fair statement?

A. That is correct.

<sup>636</sup> Id., at 25215.

\$16,506,000 face amount of debentures.<sup>637</sup> Since the trustee's own records showed \$35,000,000 principal amount of debentures outstanding, the trustee queried the debt certificate. The management replied that, in its opinion, the \$18,494,000 principal amount of debentures held by Eastern Utilities Investing Corporation's subsidiary, Southern Utilities General Corporation, were not outstanding. But the trustee was confronted with a variation from its own records and maintained that \$35,000,000 principal amount of debentures were outstanding. The Eastern Utilities Investing Corporation management thereupon contended that the notes of its subsidiary, Southern Utilities General Corporation, which held the \$18,494,000 principal amount of the parent's debentures, were worth the face amount of these debentures because the fact that Eastern Utilities Investing Corporation "owned" even indirectly its own debt (the debentures) would reduce the debt it would have to pay by the principal amount of these debentures.<sup>638</sup> And it was in connection with this certificate that the trustee first considered asking for an appraisal.<sup>639</sup>

At no time up to April 12, 1932, did the trustee, The New York Trust Company, even consider demanding an appraisal of the assets to ascertain whether the required asset coverage for the debentures existed—whether the "touch-off" clause of the indenture had already been set off. Mr. Cooper testified:<sup>640</sup>

Q. Then your testimony is that prior to April 12, 1932, The New York Trust Company did not give any consideration to the question of whether to ask that an appraisal be made of the assets of the Eastern Utilities Investing Corporation?

A. That is true.

However, no independent appraisal was made. The trustee requested a new certificate<sup>641</sup> containing a recital that \$35,000,000 of principal amount of Eastern Utilities Investing Corporation were outstanding, but the investment company did not comply with this request.

The trustee's letter of June 29, 1932,<sup>642</sup> "requesting" an amended certificate might reasonably have been construed to be notice of a failure to file a proper certificate of the debt outstanding as of December 31, 1931; and consequently to have started the 90-day period within which a proper certificate would have to be filed under the indenture.<sup>643</sup> However, the trustee did not intend it as such,<sup>644</sup> no

<sup>637</sup> Id., Commission's Exhibit No. 3782, Items 42 and 43.

<sup>638</sup> Id., at 23821-6, 23836, and Commission's Exhibit No. 3782, Items 49, 58, 59, and 66.

<sup>639</sup> Id., Commission's Exhibit No. 3782, Items 49, 58, 59, and 61.

<sup>640</sup> Id., at 23769.

<sup>641</sup> Id., Commission's Exhibit No. 3782, Item 66.

<sup>642</sup> Id., Commission's Exhibit No. 3782, Item 66. I. L. Tappen, counsel appearing on behalf of The New York Trust Company explained during the course of the public examination that "the default consists of the failure to supply the certificate" and that the default matures and the debentures can be declared due after the 90-day period of grace following demand by the trustee. His statement in full follows: "Mr. TAPPEN. The 90-day period mentioned in subsection [d] of Section 2 of Article 6 of the indenture relates to the period after which having given demand the trustee in its discretion, or if requested by 15 percent of the bonds, must declare the principal of the debentures due. The default consists of the failure to supply the certificate. The 90-day period is a period of grace after which the bonds can be declared due. The default matures, in other words."

<sup>643</sup> Id., at 23471.

<sup>644</sup> Id., at 23837.

additional certificate was filed, and the trustee took no action other than taking part in conferences with the management and the bankers and exchanging correspondence.

c. Dividends Taken Principally by the Control Interests While a Default Existed Under the Indenture

As has been stated, The New York Trust Company, the trustee, received in April 1932 the formal certificate from Eastern Utilities Investing Corporation, which the trustee questioned.<sup>645</sup> Thereupon the bankers, Harris, Forbes & Company advised the trustee that the exchange offers for the Eastern Utilities debentures were, in their opinion, favorable to the debenture holders and that the bankers were recommending the acceptance of the offer. Mr. Cooper testified:<sup>646</sup>

Q. That is in April 1932, Chase, Harris, Forbes advised you that the exchange offers pending at that time were favorable to the Eastern Utilities Investing Corporation debenture holders?

A. It is my recollection that at that time we were advised that in their opinion that was the only solution for the Eastern Utilities debenture holders.

Q. And that they were recommending the exchange?

A. That is my recollection.

Mr. Cooper gave as the reason why the trustee did not attempt to enforce the default the following explanation:<sup>647</sup>

A. \* \* \* No default was called at any time prior [to April 8, 1933], because we felt there was an opportunity of persuading the company to surrender these \$18,494,000 of debentures voluntarily, and that if we would call a default, those debentures might conceivably fall in the hands of another creditor. Also, for the reason that we did not wish to interfere with the exchange of Eastern Utilities debentures for Associated Gas debentures, because we had been advised by the principal underwriter.

Q. That is Harris, Forbes?

A. Chase, Harris, Forbes, whom we felt had more information respecting the distribution of the exchange than any other party, and who recommended the exchange in the interests of the Eastern Utilities debenture holders.

The failure to call the default gave Associated Gas and Electric Company additional time within which to persuade the debenture holders to accept the exchange offers. Mr. Cooper testified:<sup>648</sup>

Q. You realized, did you not, that the passage of time gave further opportunity to the Associated Gas and Electric Company to carry out its exchange program?

A. Yes, sir.

Associated Gas and Electric Company had caused Eastern Utilities Investing Corporation to continue to declare and pay cash dividends on the Eastern Utilities Investing Corporation preferred stocks up

<sup>645</sup> Id., at 24593-5.

<sup>646</sup> Id., at 23839.

<sup>647</sup> Id., at 23837-8.

<sup>648</sup> Id., at 23840. Mr. Cooper supplemented his answer by saying (id., at 23840-2; see also Commission's Exhibit No. 3772, Item 39): "Well, I think their exchange offer expired for a while in there, but during most of the period that is true." Evidence then brought to his attention indicates that exchange offers were practically continuous.

to April 1, 1932. By the payment of these dividends the asset protection of the debentures had again been diminished.<sup>649</sup>

Through April 1 of 1932, approximately \$560,000 in cash dividends was paid on these preferred stocks,<sup>650</sup> of which stocks substantial blocks were held by Associated Gas and Electric Company.<sup>651</sup> The cash dividends, therefore, went largely to that company.<sup>652</sup> Mr. Cooper, of The New York Trust Company, the trustee, testified:<sup>653</sup>

Q. What materiality did you see in the fact that this substantial amount of preferred stocks of Eastern Utilities Investing Corporation [was] held by Associated Gas and Electric Company?

A. It raised the question of whether the interests of debenture holders were not being sacrificed in the interests of the Associated Gas & Electric System.

On April 12, 1932, Eastern Utilities Investing Corporation filed the certificates which showed that a discrepancy existed between them and the records of the trustee. On May 25, 1932, Eastern Utilities Investing Corporation answered a telephone inquiry from the trustee by saying that the difference between the amount of debentures recorded by the trustee as outstanding and the amount claimed by the company to be outstanding was represented by debentures reacquired and held by the subsidiary of Eastern Utilities Investing Corporation.<sup>654</sup>

On June 13, 1932, counsel for The New York Trust Company advised the trustee to give Eastern Utilities Investing Corporation notice of an apparent event of default under Section 14 of Article 3 of the indenture, which required an asset coverage of 125%.<sup>655</sup> Mr. Cooper testified:<sup>656</sup>

Q. In its letter of June 13, 1932, counsel advised The New York Trust Company to give Eastern Utilities Investing Corporation notice of apparent default under Section 14 of Article 3; isn't that right?

A. Yes, sir.

Q. What is the requirement of Section 14, Article 3, in your own words?

A. That we serve written notice on the company of noncompliance with the requirement.

Q. Of noncompliance with what requirement?

A. The requirements respecting the asset coverage.

Q. With respect to what percentage of asset coverage?

A. 125%.

On June 15, 1932, the trustee sent to Eastern Utilities Investing Corporation a letter, drafted by counsel for the trustee, giving the investment company notice that an apparent default had occurred under Article III, particularly with respect to Section 14 of the indenture which required the total assets of the company to be equal to at least 125% of the aggregate indebtedness of the company and

<sup>649</sup> Id., at 24595-6. It will be recalled that the portfolio switch of September 30, 1931, had diminished this asset protection. It was shortly before (i. e., January 1932) that the controlling interests caused Eastern Utilities Investing Corporation to borrow \$325,000 from The Public National Bank and Trust Company of New York. (See *supra*, note 466.)

<sup>650</sup> Op. cit. *supra*, note 6, at 23843.

<sup>651</sup> Id., at 23810.

<sup>652</sup> Id., at 23842.

<sup>653</sup> Id., at 23811.

<sup>654</sup> Id., Commission's Exhibit No. 3782.

<sup>655</sup> Id., Commission's Exhibit No. 3782, Item 55.

<sup>656</sup> Id., at 23814.



requesting a statement of any reasons the company had for believing that it was not now in default.<sup>657</sup>

It will be recalled that the System management had taken the position that as of December 31, 1931, Eastern Utilities Investing Corporation had only \$16,506,000 of debentures outstanding (eliminating from the amount outstanding the \$18,494,000 of debentures held by Eastern Utilities Investing Corporation's "graveyard" subsidiary), that the fair value of the corporation's assets was then \$27,925,331, and that consequently the ratio of debt to assets was over 150%, and dividend declarations were permissible.

The trustee was claiming that \$35,000,000 principal amount of these debentures were outstanding and that, if so, "it would appear that the company may be in default through failure to maintain 125% asset coverage and otherwise."<sup>658</sup>

Mr. Cooper testified:<sup>659</sup>

Q. And what did you ask Eastern Utilities Investing Corporation to do?

A. We asked them as promptly as possible to give us any reasons they might have for believing the company was not in default under these sections.

\* \* \* \* \*

Q. The letter did not declare a default under the sections requiring the filing of certificates with the trust company, did it?

A. No, sir.

Q. Nor did it declare a default under the provision with respect to 150 percent and 125 percent coverage?

A. No, sir.

Q. Did Eastern Utilities Investing Corporation reply to your letter?

A. Yes, sir.

Q. Under what date?

A. Under date of June 21, 1932.

Q. And what was the suggestion which Eastern Utilities Investing Corporation made in that letter?

A. They state that they are not entirely satisfied that the position taken by our counsel is correct, and that even though the position of our counsel was correct, that on that basis there was still no default because the assets would have to be increased as the funded indebtedness which was shown outstanding.

Q. You mean that Eastern Utilities Investing Corporation suggested that the certificates be amended by adding as of December 31, 1931, \$18,494,000 of debentures to outstanding debt, and \$18,494,000 to assets?

A. That is correct.

\* \* \* \* \*

Q. But you knew that even on the basis of Eastern Utilities Investing Corporation's suggestion, a default would exist with respect to the requirement that 150 percent of assets be maintained?

A. Well, yes; which was only, I believe, with reference to the payment of dividends.

Q. That's right. But the trustee took no action to declare an actual default under the 150-percent requirement?

A. That is correct.

Under date of June 29, 1932, the trustee wrote a letter to Eastern Utilities Investing Corporation asking "that new certificates be filed

<sup>657</sup> Id., at 23821-3, and Commission's Exhibit No. 3782, Item 58.

<sup>658</sup> Id., at 23822.

<sup>659</sup> Id., at 23822-5.

under said Section, showing the facts as you now state them to have existed on said date (December 31, 1931)."<sup>660</sup>

It was not until about nine months later when, under date of April 8, 1933, the trustee gave Eastern Utilities Investing Corporation notice that it had defaulted.<sup>661</sup> The reason given was that the corporation had failed to file the certificates due April 1, 1933. This notice gave Eastern Utilities Investing Corporation ninety days' grace within which to cure the default. Before the ninety days expired, the "System" had succeeded in amending the indenture so as to eliminate this and all other "protective provisions" under which Eastern Utilities Investing Corporation had defaulted.

#### 8. EXCHANGE OFFER BY GENERAL FINANCE CORPORATION IN AUGUST 1932

On August 18, 1932, an offer was made by The General Finance Corporation<sup>662</sup> to the holders of Eastern Utilities Investing Corporation 5% Gold Debentures to exchange their debentures for either \$1,000 principal amount of Associated Gas and Electric Company 5% Convertible Obligations, Series A,<sup>663</sup> or \$900 principal amount of Associated Gas and Electric Company Gold Debentures, Consolidated Refunding 4½% Series, due 1958.<sup>664</sup> That offer was made subject to withdrawal without notice.<sup>665</sup> On November 5, 1932, however, the same offer was renewed for a limited period with the right of termination reserved by The General Finance Corporation within its discretion.<sup>666</sup>

The General Finance Corporation, "an indirect subsidiary of Associated," was used by the Associated System as the vehicle for reorganizing companies that required reorganization.<sup>667</sup> While the \$18,494,000 principal amount of Eastern Utilities Investing Corporation debentures was held by Southern Utilities General Corporation these debentures could not be voted if challenged, because the indenture prohibited the voting of debentures held by a subsidiary.<sup>668</sup> Accordingly these debentures were transferred in October 1932 to The General Finance Corporation, which was another subsidiary of Associated Gas and Electric Company.<sup>669</sup> By this transfer the debentures were held within the "System" by a company which could vote the deben-

<sup>660</sup> Id., Commission's Exhibit No. 3782, Item 66.

<sup>661</sup> Id., Commission's Exhibit No. 3782, Item 88. On March 15, 1933, default was made in the payment of interest.

<sup>662</sup> The General Finance Corporation was the corporation which, in October 1932, acquired the \$18,494,000 of Eastern Utilities Investing Corporation debentures originally placed in the "graveyard" subsidiary, Southern Utilities General Corporation, but which, upon protest from the bankers, returned these debentures to Southern Utilities General Corporation in February 1933. (See *infra*.)

<sup>663</sup> By May 12, 1933, \$1,000 principal amount of these convertible obligations was admitted to be worth considerably less than \$85. (Id., Commission's Exhibit No. 3772, Item 39.)

<sup>664</sup> In May of 1932, each holder of a \$1,000 Eastern Utilities Investing Corporation debenture was offered \$1,000 principal amount in the Consolidating Refunding 4½% series of 1958. (See *supra*.)

<sup>665</sup> Op. cit. *supra*, note 6, Commission's Exhibit No. 3772, Item 39.

<sup>666</sup> Ibid.

<sup>667</sup> Id., at 25999.

<sup>668</sup> Op. cit. *supra*, note 6, Commission's Exhibit No. 3771.

<sup>669</sup> Id., at 26986.

tures and thereby control any reorganization of Eastern Utilities Investing Corporation.<sup>670</sup> By that time, it was considered impossible "to avoid a default."<sup>671</sup> However, the bankers refused to support certain exchange offers unless the debentures were returned to Southern Utilities General Corporation.<sup>672</sup> Accordingly, in February 1933 the transfer to The General Finance Corporation was rescinded as of the date of the transfer.<sup>673</sup>

## 9. EXCHANGE OFFER OF FEBRUARY 1933 AND SOLICITATION OF PROXIES

On February 16, 1933, of the \$35,000,000 of debentures originally issued, \$6,135,000 were outstanding with the public, \$18,795,000 were held by the wholly-owned subsidiary of Eastern Utilities Investing Corporation, and \$10,070,000 were held by Associated Gas and Electric Company and/or its subsidiaries.<sup>674</sup> The "System" was, therefore, short of the required 85% of the principal amount of outstanding debentures necessary to amend the indenture.<sup>675</sup> The "System" sought to obtain sufficient additional debentures to make up the requisite percentage. On February 16, 1933, The General Finance Corporation offered to the Eastern Utilities Investing Corporation debenture holders either \$1,000 principal amount of Associated Gas and Electric Company 4% Gold Debentures, due 1983, or at their option, \$1,000 principal amount of Associated Gas and Electric Company Income Debentures due 1983. That offer was to expire March 22, 1933.<sup>676</sup>

The bankers, in their letter of February 16, 1933 to debenture holders recommended the acceptance of the offer and stated:<sup>677</sup>

The Indenture under which your Debentures were issued provides, among other things, that so long as any of the Debentures are outstanding the fair value of the assets of the Company shall be equal to at least 125% of the aggregate amount of all indebtedness of the Company. It further provides that any deficiency under such provision continued for 60 days after notice to the Company from the Trustee, shall constitute a default. The unprecedented decline in security values has made it apparent that an upturn in quoted values would be necessary to avoid such default. Cash dividends on the Corporation's preferred stocks were discontinued some time ago.

\* \* \* \* \*

We feel that the best interest of the Debenture holders would be served by avoiding a default and its eventualities. Accordingly, arrangements have been

<sup>670</sup> Op. cit. supra, note 41, pp. 352-3.

<sup>671</sup> Id., at 352.

<sup>672</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3842, Item 53.

<sup>673</sup> Id., at 26986.

<sup>674</sup> Id., Commission's Exhibit No. 3772, Item 39.

<sup>675</sup> Amendment of the indenture required 85% of debentures entitled to vote. (Id., Commission's Exhibit No. 3771, Part I.) If the \$18,795,000 held by Eastern Utilities Investing Corporation's subsidiary were not challenged and were voted along with the \$10,070,000 held by other Associated Gas and Electric Company subsidiaries, resulting in a total of \$28,865,000 for the amendment desired by the "System," the "System" would have only 82.47%. If the \$18,795,000 of debentures held by the subsidiary of Eastern Utilities Investing Corporation were disqualified from voting, the "System's" vote (of \$10,070,000 out of \$16,205,000) would be even less—only a fraction over 62%.

<sup>676</sup> Id., Commission's Exhibit No. 3772, Item 39.

<sup>677</sup> Ibid.

made for the exchange of these Debentures for securities of the Associated Gas and Electric Company under the enclosed offer of The General Finance Corporation dated February 16, 1933.

On March 15, 1933, The General Finance Corporation repeated its aforesaid offer and stated:<sup>678</sup>

\* \* \* we agree that in the event of our exchange offer becoming effective, the undersigned would pay to the holders of deposit receipts at the time of delivery of the new securities an amount equivalent to the interest represented by the March 15, 1933 coupons on all deposited Eastern Utilities Investing Corporation Debentures, if such interest had not theretofore been paid by Eastern Utilities Investing Corporation.

The March 15, 1933, interest on the Eastern Utilities Investing debentures was paid to those debenture holders who accepted this exchange but was not paid to those who did not accept the offer.

On March 22, 1933, The General Finance Corporation, announcing that the public held less than 15% of the \$35,000,000 of debentures originally issued extended the offer to April 6, 1933, and then later extended the offer again to May 1, 1933.<sup>679</sup>

On May 12, 1933, Eastern Utilities Investing Corporation admitted, in order to induce consent to the proposed amendment of the indenture,<sup>680</sup> that, if the company had to be liquidated, the holders of a \$1,000 debenture would receive securities having a market value of only \$85.<sup>681</sup>

Eastern Utilities Investing Corporation at this time was obviously in a most distressed financial condition. However, despite the precarious condition of the company, the management continued by implication to represent to its security holders that an event of default had not as yet occurred:<sup>682</sup>

The unprecedented decline in security values has made it apparent that a material upturn in quoted values would be necessary to avoid such a default.

It was admitted that, based on prevailing quotations, the above list of securities, representing the proportion of the portfolio distributable to each \$1,000 debenture of Eastern Utilities Investing Corporation, had a market value on May 12, 1933, of approximately \$85. Admittedly, the assigned value of the portfolio had shrunk from \$2,200 per \$1,000 debenture (an asset coverage of 220%) in April

<sup>678</sup> Ibid.

<sup>679</sup> Ibid.

<sup>680</sup> See *infra*.

<sup>681</sup> *Id.*, Commission's Exhibit No. 3772, Item 39. These securities were listed as follows:

7 shares General Gas & Electric Corporation Class A common stock, 4.9 shares Associated Gas and Electric Company \$5 Dividend Series Preferred Stock, 9.4 shares Associated Gas and Electric Company \$4 Cumulative Preference Stock, 6 shares Associated Gas and Electric Company \$6.50 Cumulative Preference Stock, \$1,112.18 principal amount Associated Gas and Electric Company 5% Convertible Obligations, \$13.90 principal amount Associated Gas and Electric Company 7% Interest Bearing Scrip due February 15, 1938.

The list of these six securities, which had a market value of \$85 per \$1,000 of Eastern Utilities Investing Corporation debentures outstanding, included over \$1,100 principal amount of Associated Gas and Electric Company's 5-percent convertible obligations—the same security which not very long before had been offered to holders of Eastern Utilities Investing Corporation debentures in an exchange, on a par-for-par basis. (*Id.*, at 25998-9.)

<sup>682</sup> *Id.*, Commission's Exhibit No. 3772, Item 39.

1929 to \$85 per \$1,000 debenture (or 8½% coverage) on May 12, 1933, without the "protective provisions" of the indenture having been brought into operation, yet a single step had not been taken for the protection of the debenture holders during this decline, although complete reports were furnished to both the company and the bankers as to the company's financial condition and the trustee had been put on notice that the company must be in default.

The company stated, in its letter of May 12, 1933, in conclusion:<sup>683</sup>

Based on prevailing quotations, the above list of securities would have a present market value of approximately \$85 but it is not probable that even this amount would be realized in the event of this corporation being liquidated and all of its investments disposed of at a forced public sale.

Furthermore, the expenses of such liquidation and sale would undoubtedly be considerable in amount and would, of course, be deducted from the proceeds of the sale so that the amount received by the holder of a \$1,000 debenture of this corporation would probably be materially less than the figure given above as representing the present market value of the pro rata share of this corporation's investments applicable to each \$1,000 principal amount of its debentures outstanding.

In view of the foregoing, there does not seem to be any doubt but that it is distinctly in the best interests of this corporation's debenture holders to so amend the indenture that the debentures cannot be declared to be in default and the liquidation of this corporation and forced sale of its assets precipitated.

If you will be unable to attend the meeting in person we urge you to sign and return to us promptly the enclosed proxy, and also, if your debentures are not registered, the certificate of deposit in the form enclosed herewith.

On May 13, 1933, The General Finance Corporation announced that its offer had become effective.

On May 15, 1933, Associated Gas and Electric Company outlined a Plan of Rearrangement of Debt Capitalization which was applicable to the fixed interest obligations of that company including its 4% Gold Debentures due 1985, which The General Finance Corporation had been exchanging for Eastern Utilities Investing Corporation debentures.<sup>684</sup>

On June 5, 1933, The General Finance Corporation wrote former Eastern Utilities Investing Corporation debenture holders who had accepted The General Finance Corporation's offer to exchange into Associated Gas and Electric Corporation 4% Gold Debentures due 1983 that their deposit receipts could be exchanged under the "Recap" Plan of Associated Gas and Electric Company "in lieu of the actual Debentures themselves." The letter stated:<sup>685</sup>

This will eliminate the necessity of returning your Deposit Receipt to the Depositary, awaiting the delivery of the 4% Debentures due 1983, and then forwarding the Debentures—for deposit under the new Plan.

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<sup>683</sup> Ibid.

<sup>684</sup> Id., Commission's Exhibit No. 3771, Part I (letter of The General Finance Corporation dated June 5, 1933 to the holders of Deposit Receipts for Eastern Utilities Investing Corporation debentures). See "Plan of Readjustment of Capitalization of the Associated Gas and Electric Company," Sec. II, Part VII of the Report of this Commission on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees.

<sup>685</sup> Ibid.

On June 26, 1933, The General Finance Corporation wrote to the holders of Eastern Utilities Investing Corporation's Debentures, extending its exchange offer on an amended basis, stating:

For a limited time it has been determined to accept further tenders of the debentures which you hold for exchange for such Associated Gas and Electric Company 4% Gold Debentures due 1983, stamped for deposit under the plan of rearrangement of capitalization of Associated Gas and Electric Company on a par for par basis.

By June 26, 1933, which was five days after the debenture holders meeting described below, the company had succeeded in reducing the amount of debentures outstanding in the hands of the general public<sup>686</sup> to less than 7% of the original \$35,000,000 of debentures.

## I. AMENDMENT OF INDENTURE, JUNE 1933

By May 12, 1933, the "System" apparently had attained, as the result of the successive exchange offers, control of enough debentures to vote an amendment of the indenture, even if the \$18,795,000 of Eastern Utilities Investing Corporation debentures held by its subsidiary were disqualified from voting. The "System" then caused Eastern Utilities Investing Corporation to demand that the trustee call a meeting of debenture holders for the purpose of amending the indenture. The amendment was to eliminate from the indenture all provisions which gave the trustee or the debenture holders the right to call a default of such debentures, upon any ground except for the nonpayment of principal or interest.<sup>687</sup> The amendment would therefore eliminate the "protective provisions" requiring maintenance of certain<sup>688</sup> asset coverage ratios. The trustee promptly complied with this request on May 12, 1933, setting the meeting for the earliest possible date.<sup>689</sup>

For approximately a year the trustee had not taken any affirmative action to enforce the provisions of the indenture although it was aware of defaults. In essence, the trustee had confined its activities to conferences with the issuer and its bankers and to routine answers to the inquiries of debenture holders whom the trustee referred to the investment bankers and the investment company for information and advice, without warning them of the serious condition of the company.<sup>690</sup>

In considering the trustee's action in connection with the debenture holders' meeting, it may be well to refer to some of the letters it had previously received from public debenture holders and how it had answered them.

On May 27, 1932, by receipt of a letter from a debenture holder, the trustee was put on notice of a possible event of default under Section

<sup>686</sup> *Ibid.* The offers made by The General Finance Corporation were further extended on July 12, 1934, at which time only about 4% were outstanding in the hands of the general public. The remaining holders of debentures were solicited by The General Finance Corporation on November 3, 1934, to exchange their debentures "for the more secure debentures of the Associated Gas and Electric Corporation". (*Id.*, Commission's Exhibit No. 3772, Item 39.)

<sup>687</sup> *Id.*, at 23852-7, and Commission's Exhibit No. 3782, Item 94.

<sup>688</sup> *Id.*, Commission's Exhibit No. 3771.

<sup>689</sup> *Ibid.*

<sup>690</sup> See *infra* and also *op. cit. supra*, note 6, at 23857, and Commission's Exhibit No. 3782.

14, Article III of the indenture requiring a 125% asset coverage of the outstanding debentures.<sup>691</sup> Thereupon the trustee communicated with its counsel with respect to this letter, pointing out to counsel that Associated Gas and Electric Securities Company, Inc., was then making an exchange offer of Associated Gas and Electric Company debentures for those of Eastern Utilities Investing Corporation and stating:<sup>692</sup>

We wonder whether the question whether a default has occurred, and if so what action should be taken by us as Trustee may not be determined independently of the question of registering certain of the Eastern Utilities Investing Corporation debentures in the name of a subsidiary of the Eastern Utilities Investing Corporation.

Counsel for the trustee advised:<sup>693</sup>

\* \* \* We think it wise that the trustee call to the attention of the corporation the apparent default in the observance by the corporation of the provisions of Section 14 of Article III of the Debenture Agreement requiring that the total assets of the corporation shall be equal to at least 125% of the aggregate amount of all indebtedness of the corporation. We are therefore proposing for your signature a form of letter \* \* \*

Upon this advice of counsel, the trustee, on June 15, 1932, wrote to the Eastern Utilities Investing Corporation:<sup>694</sup>

We do not understand that debentures reacquired and held by a wholly owned subsidiary \* \* \* have the status [of debentures reacquired by the company] \* \* \*. It therefore seems to us that the debentures held by the subsidiary must be regarded as "outstanding" for all of the purposes of the debenture agreement. If the debentures are outstanding, it would appear that the company may be in default in the performance of its covenants and agreements contained in Sections 8 to 16 inclusive of Article III of the debenture agreement, particularly Section 14 [providing for 125% asset coverage].

Section 13 of Article III of the debenture agreement provided:<sup>695</sup>

The Company will not, so long as any of the debentures are outstanding, declare any dividend other than a stock dividend, on any class or series of its stock if, at the time of the declaration of such dividend, the total assets of the Company, exclusive of the fair value of securities then pledged as security for temporary indebtedness are less than 150% of the then outstanding funded indebtedness of the Company, or would, by reason of the payment of such dividend be reduced to less than 150% of its then outstanding funded indebtedness.

In response to the inquiry regarding the apparent defaults existing with respect to asset coverage and by reason of dividend payments, the company replied, on June 21, 1932, to the trustee:<sup>696</sup>

Inasmuch as the bonds in the treasury \* \* \* are worth to this Company 100 cents on the dollar, as indebtedness of this Company, the value of the assets as shown by the certificate filed with you should be increased from approximately \$28,000,000 shown therein to over \$46,000,000. This asset value is substantially in excess of 125% of the \$35,000,000 principal amount of bonds outstanding.

<sup>691</sup> Id., Commission's Exhibit No. 3782, Item 50.

<sup>692</sup> Id., Commission's Exhibit No. 3782, Item 52.

<sup>693</sup> Id., Commission's Exhibit No. 3782, Item 55.

<sup>694</sup> Id., Commission's Exhibit No. 3782, Item 58.

<sup>695</sup> Id., Commission's Exhibit No. 3771.

<sup>696</sup> Id., Commission's Exhibit No. 3782, Item 59.

In this letter the corporation admitted that the ratio of \$46,000,000 assets to \$35,000,000 of obligations was less than the required 150% asset coverage required for current payment of cash dividends in accordance with the indenture. To satisfy the asset ratio coverage for dividends, \$52,000,000 of assets was needed. The letter which relates to a certificate of asset value as of December 31, 1931, in effect constituted an admission that the dividends paid in the spring of that year on the preferred had been declared in violation of the indenture provisions.

Although The New York Trust Company may not have been aware, at the time of receipt of this letter, that a total of \$572,998.50 cash had been currently paid as dividends, of which \$562,000 had been paid to companies in the Associated Gas & Electric System,<sup>697</sup> the trustee was aware that Eastern Utilities Investing Corporation had theretofore during 1932 paid dividends in cash.<sup>698</sup> Such payments were particularly noted by the trustee in its letter of June 24, 1932, forwarding to counsel for further consideration the aforementioned reply of Eastern Utilities Investing Corporation.<sup>699</sup> However, the trustee, on June 29, 1932, merely asked for a new certificate, saying:<sup>700</sup>

It would appear that the certificate heretofore filed with us pursuant to Section 15 of Article III, showing as of December 31, 1931, the fair value of the total assets of the Company does not reflect accurately such fair value. It would also appear that the certificate filed under said Section 15 showing the amount of outstanding debentures is inaccurate to the extent that it fails to include the \$18,494,000 of debentures held by your subsidiary. We, therefore, request that new certificates be filed under said Section showing the facts as you now state them to have existed on said date.

<sup>697</sup> As of December 31, 1932, the following shares of Eastern Utilities Investing preferred stock were outstanding on which dividends were paid during the first part of 1932 at the following rates :

Security	Number of shares <sup>a</sup>	Rate <sup>b</sup>	Total paid
\$5 preferred.....	75,000	\$2.50	\$187,500.00
\$6 preferred.....	68,331	1.50	102,496.50
\$7 preferred.....	11,724	1.75	20,517.00
Participating preferred.....	174,990	1.50	262,485.00
Total dividends paid.....			572,998.50

of which the public held the following shares and received the following dividends:

Security	Number of shares <sup>a</sup>	Rate <sup>b</sup>	Total paid
\$5 preferred.....	639	\$2.50	\$1,597.50
\$6 preferred.....	772	1.50	1,158.00
\$7 preferred.....	3,744	1.75	6,552.00
Participating preferred.....	1,123	1.50	1,684.50
Total received by the public.....			10,992.00

and the Associated Gas & Electric Co. and its affiliates received the balance of about \$562,000.

<sup>a</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3772, Item 6.

<sup>b</sup> Id., Commission's Exhibit No. 3782, Item 63.

<sup>698</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3782, Items 61 and 63.

<sup>699</sup> Id., Commission's Exhibit No. 3782, Item 61.

<sup>700</sup> Id., Commission's Exhibit No. 3782, Item 66.



On the same day Mr. Cooper prepared a memorandum for the trustee's counsel showing the amount per share paid in cash and saying " \* \* \* we note substantially all of the preferred stocks, excepting the \$7 Cumulative Preferred, are owned by the Associated Gas and Electric Company \* \* \* " <sup>701</sup>

Although the trustee disagreed with the management's argument that it had fulfilled the covenant to maintain a ratio of assets to debt of 125%, although the trustee considered the April 1932 certificate to be incorrect, and although the trustee knew of the declaration of these dividends after the ratio of assets to debt had fallen below the required 150% and thought that "it raised the question whether the interests of debenture holders were not being sacrificed in the interests of the Associated Gas & Electric System," nevertheless the trustee took no action to enforce the remedies of the indenture. Not until April 8, 1933, after the March 15, 1933, interest had been defaulted and the April 1, 1933, certificates had not been filed, did the trustee place the remedial machinery of the indenture into operation. It then chose to give notice only that a default had occurred for failure to file the April 1, 1933, certificates and that if none were filed within 90 days it might declare the debentures due and payable. Mr. Cooper testified: <sup>702</sup>

Q. Prior to that time it [the trustee] had neither called a default nor started any period of grace running?

A. Well, we had notified the company that we felt that they were in default in their covenants, but we had not taken any action to enforce the remedies of the indenture.

However, during the period of a year after it told the company it was in apparent default, the trustee withheld that fact from the debenture holders and referred inquiries to the corporation and the investment bankers. In response to an inquiry of a debenture holder typical of many asking for general and specific information regarding the condition of the debentures—inquiries apparently made by debenture holders to determine the advisability of accepting pending exchange offers—the trustee, on July 1, 1932, wrote: <sup>703</sup>

The debenture agreement does not require the company to keep us informed as to its portfolio, and we have no information in respect thereto. We suggest that you communicate direct with the company upon this subject. \* \* \* last certificate filed with us shows that as of December 31, 1931, the corporation had not pledged any of its assets to secure temporary indebtedness.

So, too, in response to a letter of a debenture holder, dated August 1, 1932, asking, "Can you give me any information concerning Eastern Utilities Investing Corporation gold debentures?" the trustee, pursuant to advice of counsel, <sup>704</sup> replied, "We are in receipt of your letter \* \* \*. We suggest that you communicate directly with Chase Harris Forbes Corporation."

<sup>701</sup> Id., Commission's Exhibit No. 3771, Item 63.

<sup>702</sup> Id., at 23811, 23849, 23856, and Commission's Exhibit No. 3782, Items 42, 43, 63, 66, and 84.

<sup>703</sup> Id., Commission's Exhibit No. 3782, Item 68.

<sup>704</sup> Id., Commission's Exhibit No. 3782, Items 71 and 73.

When examined with respect to the relative attention shown to the requests of the debenture holders and the issuing company, Mr. Cooper testified:<sup>705</sup>

Q. So that The New York Trust Company issued the call of meeting on the same day that it got the request from the corporation with the specifications of the proposed amendments: is that right?

A. The formal request.

Q. It issued the notice to call the meeting: isn't that right?

A. That is correct.

Q. When The New York Trust Company was answering inquiries from outside debenture holders, it often took considerable time in answering the inquiries, did it not?

A. That is correct.

Q. And also it gave them just the bare bones of the information contained in the certificates filed; isn't that right?

A. That is right.

The statements of Eastern Utilities Investing Corporation had failed to inform the public of its actual financial condition and the trustee had failed to take any affirmative action to protect the debenture holders. The auditors, Haskins & Sells, in their audit reports had failed to comment on the increasing proximity of the debentures' asset coverage to the "touch-off" point.<sup>706</sup> Had this disclosure been made soon enough some debenture holders might have succeeded in securing the consent of the holders of the requisite percentage of the outstanding debentures necessary to compel the trustee to accelerate the maturity date of the debentures. Furthermore, during the time that the Associated System was pressing its program of switching the holders of the debentures of Eastern Utilities Investing Corporation into securities of other companies of the "System," these debenture holders were never told that a default had occurred, although the management's attention had been specifically called to the occurrence of a default by Haskins & Sells around March or the early part of April 1933,<sup>707</sup> and although even the trustee had on June 15, 1932, written the management that "it would appear that the company may be in default,"<sup>708</sup> and although exchange offers to preferred stockholders had since the fall of 1931 been warning them of an impending default.<sup>709</sup>

<sup>705</sup> Id., at 23857.

<sup>706</sup> Id., at 24351-2. The auditors contended that they did not see any advantage to the investor of a disclosure of the nearness of the asset coverage to the "touch-off" point. Thus, just as the trustee attempted to shift its burden to the banker, the accountants attempted to shift the burden to the trustee. Mr. Bowman testified (id., at 24352):

Q. What did you insert in your auditors' report for 1931 to fulfill your obligation to the public?

A. We showed the value of the securities.

The value was based on the company's valuation, except that it was the practice to show the aggregate market value of securities having any market quotation and the aggregate carrying value of securities for which no quotation could be found (id., at 24357-9).

<sup>707</sup> Id., at 24289-91.

<sup>708</sup> Id., Commission's Exhibit No. 3782, Item 45.

<sup>709</sup> Id., Commission's Exhibit No. 3771, Item 40, et seq.

The trustee could have started action to collect payment of the principal and interest.<sup>710</sup> However, the trustee did not take such action; nor did the trustee even request a list of the portfolio securities or the basis on which these securities had been valued by the company, although the trustee believed it could have obtained this information merely on request.<sup>711</sup>

After discussion with counsel of Eastern Utilities Investing Corporation over a period of time, the New York Trust Company complied with the request of the management of the Associated System dated May 12, 1933, to call an immediate meeting to amend the indenture and on the same day called such a meeting for June 21, 1933, the earliest date possible.<sup>712</sup> Although the trustee advised the management that by calling the meeting it was not thereby giving approval to the proposed amendment, nevertheless the trustee did not protest against the amendment.<sup>713</sup> Moreover, the trustee took no action whatsoever to advise the debenture holders of the import of the contemplated amendment or in any manner to represent their interests.<sup>714</sup>

The plans had been carefully prepared for the meeting. Every precaution had been carefully taken to prevent delay in the program of the controlling interests. The proposed annual audit report for the year 1932, submitted promptly after March 10, 1933<sup>715</sup> and showing defaults, was held in abeyance.<sup>716</sup> The annual report to security holders which for the prior four years had invariably been issued prior to May was in 1933 withheld until September.<sup>717</sup> The "System" had assured itself of the control of an adequate number of debenture votes to pass the amendments, even if the voting of its subsidiaries' holding of \$18,795,000 principal amount of debentures was disallowed. The pub-

<sup>710</sup> Id., at 23854-6. Mr. Cooper testified (id., at 23854-6) :

Q. When The New York Trust Company received this letter of May 12 from Eastern Utilities Investing Corporation, The New York Trust Company could have started action to collect payment of the interest and principal amount, could it not?

A. Yes.

Q. By that date hadn't you obtained the opinion of counsel that the trustee had a right to take action to collect the principal and interest?

A. Yes.

Q. As a matter of fact, you had that opinion a long time prior to May 12, 1933, hadn't you?

A. I don't recall.

Q. When did you receive the opinion?

A. As I recall, it was shortly after the interest was not paid.

Q. What was the approximate date of non-payment of interest?

A. March 15, 1933.

<sup>711</sup> Id., at 23866-7.

<sup>712</sup> Id., at 23857.

<sup>713</sup> Id., at 23858.

<sup>714</sup> See supra. The trustee felt that the only remedy available was to accelerate the maturity of the principal of the debentures and apply for a receiver, thereby throwing the company into bankruptcy, steps which the trustee stated it would not take. (Id., at 23850.)

<sup>715</sup> Id., at 24291 and Commission's Exhibit No. 3813.

<sup>716</sup> According to the recollection of Mr. Bowman, a partner of Haskins & Sells, when Haskins & Sells pointed out to the Associated management "around March or the early part of April [1933] that there had been a default under the terms of the bond" and submitted a rough draft of their audit report, the submission of the final certified audit was delayed until after the amendment of the indenture because "they said they were going to do something about the indenture". (Id., at 24289-91.)

<sup>717</sup> Id., Commission's Exhibit No. 3771 shows the dates of the president's letters accompanying the annual reports as—

March 11, 1929, for the 1928 report.  
February 7, 1930, for the 1929 report.  
March 23, 1931, for the 1930 report.  
April 15, 1932, for the 1931 report.  
September 9, 1933, for the 1932 report.

lic debenture holders had not been specifically advised of their rights under the terms of the indenture nor were they informed of the actual financial condition of the company. The meeting of the debenture holders was held at the earliest possible date in accordance with the terms of the indenture, to wit, June 21, 1933, or (as required by Article XII, Section 2 of the indenture) 38 days after the control interests had requested such meeting, whereas 60-days' notice was permissible.<sup>718</sup> The New York Trust Company, acting pursuant to powers granted to it by the indenture, appointed the officers to conduct the meeting and the tellers to count the votes and pass upon the eligibility of debentures to vote.<sup>719</sup>

The Tradesmens National Bank & Trust Company of Philadelphia, holding \$25,000 of debentures, had, prior to the meeting, protested against the voting of the \$18,795,000 of debentures held by Southern Utilities General Corporation, the subsidiary of Eastern Utilities Investing Corporation.<sup>720</sup> Accordingly, those \$18,795,000 of debentures were not voted,<sup>721</sup> but these votes were not needed to approve the amendment.<sup>722</sup> The Tradesmens National Bank & Trust Company also protested against the voting of any Eastern Utilities Investing Corporation debentures held in the Associated Gas & Electric System.<sup>723</sup> The indenture provided that debentures held for the benefit of the issuer should be disqualified from voting. The Tradesmens National Bank & Trust Company took the position that debentures held by Associated Gas and Electric Company and its subsidiary, Eastern Utilities Securities Corporation, were held for the benefit of the issuer, Eastern Utilities Investing Corporation, because in view of the intercorporate relationship between the three "for the purposes of this meeting those corporations should be considered as one."<sup>724</sup> It also took the position that "The use of [by] the Associated Gas and Electric Company and the Eastern Utilities Securities Corporation of the \$13,786,000 principal amount of Debentures held by them to bring about the adoption of the proposed amendments will constitute a breach of the trust imposed by law upon the majority Debenture holders not to use their control to the detriment of the minority Debenture holders." After considerable discussion at the meeting, the inspectors of the votes, appointed by the trustee, decided with the aid of an opinion of counsel, who were

<sup>718</sup> *Id.*, Commission's Exhibit No. 3771.

<sup>719</sup> *Id.*, at 23859.

<sup>720</sup> *Id.*, at 23859-60, 23874-5 and Commission's Exhibit No. 3782, Item 6. With reference to the question whether Associated Gas and Electric Company was also a subsidiary of Eastern Utilities Investing Corporation, counsel for the two companies admitted that Associated Gas and Electric Company securities held by Eastern Utilities Investing Corporation "if they become voting by reason of a continuation of a default in the payment of dividends on the Associated Gas and Electric Company preferred stock, will aggregate not more than 8% of the aggregate shares now outstanding, which, if then outstanding, will be entitled to vote." However, he submitted a certificate verified by affidavit "certifying that Associated Gas and Electric Company is not a subsidiary of Eastern Utilities Investing Corporation". (*Id.*, Commission's Exhibit No. 3782, Item 8, p. 23.)

<sup>721</sup> *Id.*, at 23859-60.

<sup>722</sup> In computing the total vote, these \$18,795,000 principal amount of debentures were deducted from the total principal amount of \$35,000,000 to arrive at a figure of \$16,205,000 as a basis for determining the percentage of the debentures needed to pass the amendments. (*Id.*, Commission's Exhibit No. 3782, Item 8.)

<sup>723</sup> *Id.*, at 23880 and Commission's Exhibit No. 3782, Items 6 and 8.

<sup>724</sup> *Ibid.*

also appointees of the trustee, that the debentures held within the "System" could be voted.<sup>725</sup>

Mr. Cooper testified:<sup>726</sup>

Q. Even though the Tradesmens Bank, a debenture holder, had protested against the voting of debentures held within the Associated System, isn't that right?

A. That is correct.

Q. And the ground of the objection was stated to be that those debentures were being held for the benefit of Eastern Utilities Investing Corporation, isn't that right?

A. Yes; within the meaning as defined in the indenture.

Q. And the question involved a consideration of a considerable amount of evidence which was received at the meeting, isn't that right?

A. That is correct.

Q. And who made the decision that debentures held within the system could be voted?

A. The inspectors of votes.

Q. Which had been selected by The New York Trust Company?

A. That is correct.

Q. Did the inspectors make that decision entirely as a result of their own personal consideration of the evidence?

A. Plus the opinion of counsel.

Q. The opinion of what counsel?

A. Mr. Bailey and Mr. Curran.

Q. Mr. Curran and Mr. Bailey were counsel for The New York Trust Company?

A. That is correct.

When examined as to his own personal opinion on whether these debentures were disqualified, Mr. Cooper, one of the inspectors of votes, testified:<sup>727</sup>

Q. What was your own individual opinion at that time as to whether the Eastern Utilities Investing Corporation debentures held within the Associated System were held for the benefit of Eastern Utilities Investing Corporation?

A. Aside from interpretation of the exact wording of the trust indenture defining what should be excluded and voted in the meeting, it seemed that it was all one system, more or less.

The Tradesmens National Bank & Trust Company, of course, did not have the benefit of an insider's knowledge of the affairs and records of the "System," nor the aid of the trustee in developing the actual situation, nor the benefit of an examination of the books and records of Eastern Utilities Investing Corporation and affiliated companies to trace the acquisition of these bonds.<sup>728</sup> The Tradesmens National

<sup>725</sup> Id., at 23880. Mr. Stix, auditor of the "System," testifying in a tax proceeding in support of the issuer's position that it should not be taxed for any profit made in the acquisition by Eastern Utilities Investing Corporation of these debentures, strongly urged that they had been reacquired from the public by "System" companies beginning as early as June 1931, for the purpose of retiring debt of Eastern Utilities Investing Corporation and not as a capital investment. (Op. cit. supra, note 41, at 336.)

<sup>726</sup> Op. cit. supra, note 41, at 23860-1.

<sup>727</sup> Id., at 23867.

<sup>728</sup> Mr. Cooper testified (id., at 23877) :

Q. In order to obtain ample evidence to determine whether or not the debentures held within the Associated Gas & Electric System were held for the benefit of Eastern Utilities Investing Corporation, or held by or for the benefit of a subsidiary of Eastern Utilities Investing Corporation, it would have been necessary, would it not, to examine various books of account and other records of system companies? And to examine witnesses as to the beneficial ownership of certain securities? Isn't that right?

A. Yes, sir.

Bank & Trust Company requested, at the meeting, certain information with respect to these reacquired bonds from the attorney representing the Associated System. Portions of these requests were granted by the "System's" attorney, but the balance of these requests were ruled by the trustee's representative to be irrelevant and therefore unavailable to the bank.<sup>729</sup>

The vote of 85% of the debentures entitled to vote was needed to effect the amendments to the indenture proposed by the management. As a result of the disqualification of the debentures held by Eastern Utilities Investing Corporation's subsidiary, only 85% of the remaining \$16,205,000 of debentures was required to pass these amendments. Through voting of debentures held by Associated Gas and Electric Company and its subsidiary, Eastern Utilities Securities Corporation, the amendments were carried by a vote of a fraction above 85%. Mr. Cooper testified:<sup>730</sup>

Q. What was the percentage of debentures voting for the amendment as compared with what you consider the debentures entitled to vote?

A. May I give an approximation, or do you want me to figure it out?

Q. If you can give a close approximation, yes.

A. We computed that \$13,774,250 principal amount constituted 85% of those entitled to vote. The actual vote in favor of the resolution was \$13,803,000 principal amount, or slightly in excess of 85 percent.

Q. So that the amendments were barely carried?

A. That is true.

Since there was a default under the indenture, the trustee was in a position to take affirmative action for the protection of the minority debenture holders. Prior to the meeting, the trustee had the right to give notice of default and proceed to enforce the indenture. However, the trustee, apparently without any independent investigation of its own, chose to accept the opinion of the bankers and of the management that the debenture holders would fare better if their rights were not pressed and the company were allowed to continue in business by being relieved of the obligation to maintain any ratio of assets to debt.

Even though the Eastern Utilities Investing Corporation had failed to pay interest on its debentures, no investigation was made by the trustee as to the composition of the portfolio<sup>731</sup> or the value of its assets or of the condition of the company; nor was any attempt made to place the company into receivership.

As early as September 1931, the trustee had been put on notice by The Fulton County National Bank and Trust Company that the Eastern Utilities Investing Corporation debentures were selling as low as 36.<sup>732</sup> Blythe & Company, Inc., an investment banking house, in a letter to the trustee dated September 30, 1931, said that that firm presumed from the phraseology of the indenture<sup>733</sup> that the trustee would notify the company in case of any default with respect to the 125% asset protection requirement. The letter specifically stated:<sup>734</sup>

<sup>729</sup> Id., Commission's Exhibit No. 3782, Item 8.

<sup>730</sup> Id., at 23884-5.

<sup>731</sup> Id., at 23866.

<sup>732</sup> Id., at 23746.

<sup>733</sup> Id., Commission's Exhibit No. 3771, Part 1.

<sup>734</sup> Id., Commission's Exhibit No. 3782, Item 23.

\* \* \* in order to do this [the trustee] must necessarily keep informed concerning the current value of the assets of the company.

Counsel for the trustee, however, held a different view.<sup>735</sup> Again, on December 15, 1931, in reply to an inquiry by one Mr. Space, the trustee admitted that it did not know the value of assets of Eastern Utilities Investing Corporation; repeated its reference to the company's covenant to maintain a relationship of 125% of total assets to indebtedness, and stated that the trustee had referred Mr. Space's letter to the issuing company, Eastern Utilities Investing Corporation, for reply. Mr. Space urged that since the debenture holders looked to the trustee for protection, it would be preferable for the trustee to inform itself as to the assets of the company instead of relying upon the certificate of the company.<sup>736</sup> Mr. Cooper testified:<sup>737</sup>

Q. If you had followed the suggestion of Mr. Space contained in his letter of December 15, to the effect that you inform yourself as to the assets of Eastern Utilities Investing Corporation, would you have been surprised to have found that Eastern Utilities Investing Corporation not only did not have 125% coverage, but had less than 100% coverage as of December 31, 1931?

A. On the basis of information which we received later, I would not have been surprised.

Moreover, in March 1932, the Spokane Savings Bank of Spokane, Washington, had requested of the trustee information with respect to statements contained in certificates due to be filed with the trustee April 1, 1932, because that bank noticed that dividends were being paid on the preferred stock of Eastern Utilities Investing Corporation, and questioned whether the 150% asset coverage required by the indenture existed.<sup>738</sup>

The firm of Haskins & Sells had, in the middle of March 1933, audited the books of Eastern Utilities Investing Corporation for the year 1932 and had promptly submitted a report on the result of its examination to the company,<sup>739</sup> in the form of a proposed audit report accompanied by a qualified certificate pointing to the default of the debentures.<sup>740</sup>

The Haskins & Sells audit for the year 1932 disclosed:<sup>741</sup>

At December 31, 1932, the ratio of the company's assets to the liabilities was less than the minimum of 125% of the former to the latter as required under Section 14 of Article III of the indenture dated as of March 15, 1929, covering the company's 5% gold debentures due March 15, 1954. Failure to maintain the prescribed ratio of assets to liabilities constituted a default under Section 2 (e) of Article VI of the indenture.

Because of the probability that the total assets of the company were less than 150% of the company's funded debt in January, 1932, the declaration of dividends at that time possibly violated Section 13 of Article III of the above-mentioned indenture. We did not attempt to compute a fair market value of

<sup>735</sup> Id., at 23747, 23753.

<sup>736</sup> Id., at 23776-7.

<sup>737</sup> Id., at 23780.

<sup>738</sup> Id., at 23791-2.

<sup>739</sup> Id., at 25697 and 24289-91.

<sup>740</sup> Id., Commission's Exhibit No. 3780-D.

<sup>741</sup> Ibid.

the securities then owned by the company, but a cursory inspection of a list of securities owned, as shown in the company's report of January 31, 1932, indicates that the total assets, including securities at their fair market value, were less than 150% of the then outstanding funded debt of the company.

Inclusion of these vital facts in the auditor's certificate was avoided as the result of the management's delay in approving the audit report on the excuse that something was being done about the indenture.<sup>742</sup> The amendments which eliminated the protective provisions of the indenture, were voted, as has been indicated, on June 21, 1933. Nine days later, or three months after the time of its audit, Haskins & Sells issued their report.<sup>743</sup> Thus, the audit report lay on the desk of the "System's" auditors from around March or the early part of April 1933 until June 1933, and the certified report of the auditors was not officially submitted to the management of the company until June 30, 1933. Moreover, in view of the amendments to the indenture effected on June 21, 1933, the accountants chose to include the statement regarding the defaults and violation of the indenture provision in their letter transmitting their audit report to the company, which would not be made public, rather than in their certificate,<sup>744</sup> which would be included in the annual report to security holders. Mr. Bowman, partner of Haskins & Sells, testified:<sup>745</sup>

Q. You knew when you submitted that certificate along with your letter of transmittal, that the letter of transmittal would not be included in the company's published annual report, didn't you?

A. We assumed that; yes.

\* \* \* \* \*

A. \* \* \* That was the reason we didn't put in the certificate, as I stated, before the default had been cured.

Q. Was a statement that a default had occurred inserted as a footnote to the balance sheet?

A. No.

The company's annual report for the year 1932 was issued on September 9, 1933. This report, of course, did not contain the auditor's letter of transmittal to the company, which mentioned the default. The annual report, however, did contain the auditor's certificate which did not mention the default. As a result, these comments of the accountants with respect to the default did not appear in the published certified report for the year 1932 and never were transmitted to the stockholders.<sup>746</sup> Mr. Bowman claims they were told the company would mention the default in its report, but actually the annual report did not state that any default had taken place. Mr. Bowman testified:<sup>747</sup>

Q. Mr. Bowman, when Haskins & Sells had completed their report, it was customary, was it not, to have a discussion with Mr. Stix concerning that report before the final report was submitted?

A. In some instances it was, and in other instances a draft would be left with him, and there might not have been any discussion.

<sup>742</sup> Id., at 24291 and op. cit. supra, note 46, at 655.

<sup>743</sup> Op. cit. supra, note 6, at 25697, and Commission's Exhibit No. 3813.

<sup>744</sup> Id., at 24291-4 and Commission's Exhibit No. 3780-D.

<sup>745</sup> Id., at 24294.

<sup>746</sup> Id., at 24294-9.

<sup>747</sup> Op. cit. supra, note 46, at 655-8.



Q. You remember the report for the year 1932 very clearly, do you not?

A. Yes.

Q. That report was discussed with Mr. Stix, the draft report, was it not?

A. I doubt whether the report as rendered was discussed with Mr. Stix.

Q. Do you remember with whom it was discussed?

A. I do not know whether it was discussed with anyone. As I remember, we held the report for some time and then finally rendered it in the form which you have there, and I am not sure that it was discussed with anyone.

Q. Do you remember why that report was held up after it was completed?

A. To the best of my recollection there was a question pending as to the default in the indenture.

Q. And do you remember what that question was?

A. The company had not the coverage required in the indenture.

Q. And why would that cause you to hold up the report?

A. We felt that it was necessary to say something about it in the report.

Q. Could you not have said that without holding up the report?

A. Do you mean "said it in the report"?

Q. Yes.

A. It was our custom to discuss the reports or show the reports or advise them of any exceptions that we were taking in the report.

Q. And you advised them that you were going to mention the default under the indenture?

A. I am pretty sure we gave some advice that it would be necessary to make a statement about the default.

Q. And they asked you to hold it up after you mentioned that?

A. I believe we were told that something was being done to cure the default.

Q. Were you told what was being done?

A. No, I do not think so. We were told later on that the indenture had been changed.

Q. Why would you be interested in holding up a report that was going to mention a default until after the default had been cured?

A. We were not interested in holding it up, but ordinarily we kept the reports around until the company was ready to publish them and use them. They were not pressing us for it and the matter was in suspense and pending final conferences, and they were just left there until they asked for them.

Q. I show you Government's Exhibit M-5, which was the report for the year 1932, and ask you why you did not mention the default in the certificate?

A. We felt that the default had been cured at that time.

Q. You mentioned the default in the letter of transmittal?

A. Yes.

Q. You knew the letter of transmittal would not be published, did you not?

A. It is not usual to publish a letter of transmittal, although it is usual for them to submit a copy of the report, and if the same thing was mentioned in the copy of the report, it would not necessarily be mentioned in the copy of the certificate.

Q. Was the fact that there had been a default mentioned in the report or in any place other than the letter of transmittal?

A. In our report?

Q. In your report?

A. No.

Q. So that the only place that you mentioned the default was in the letter of transmittal which you knew it was not customary to publish, is that right?

A. I knew it was not customary to publish, but I believe we knew that they were going to say something about it in the report.

As has been indicated, the annual report did not mention that a default had occurred. The annual letter of C. A. Dougherty, then president of Eastern Utilities Investing Corporation,<sup>748</sup> which did not go out until September 1933, did, however, say: <sup>749</sup>

The market value of the investments was estimated to be \$5,466,378.75 at December 31, 1932, and \$2,881,442.88 at August 31, 1933. The Indenture under which the debentures of this Corporation were issued provided, among other things that so long as any of the debentures are outstanding, the total assets (as therein defined, including the fair value of all securities owned) shall be equal to at least 125% of the aggregate amount of all its indebtedness. The unprecedented decline in security values had made it apparent that a material upturn in quoted values would be necessary to avoid a default, which would not have been in the best interests of the debenture holders.<sup>750</sup>

Mr. Bowman justified the action of Haskins & Sells in withholding the report for an appreciable period of time on the ground that, since the firm was hired by the management, the firm could not submit the report officially until the management had concurred in it.<sup>751</sup> Mr. Stix, the "System's" auditor, justified his delay in permitting the submission of an audit report, to the accuracy of which he did not pretend to object, on the ground that he had been too busy "to get around to it." Mr. Stix denied any implication that the report was deliberately delayed to keep the stockholders in ignorance of the condition of the debentures pending the efforts of the company to amend the indenture, saying, "I think it was held up because I was too busy to look at it."<sup>752</sup> However, Mr. Bowman testified: <sup>753</sup>

Q. Did you submit the report to the company as promptly as it was prepared?

A. We submitted a rough draft promptly.

Q. Was the delay from the submission of the rough draft until the submission of the final certified audit, due to the failure or refusal of the company's management to approve of the audit you had submitted?

A. I think it was due to the fact that they said they were going to do something about the indenture.

Q. Did the amendment of the indenture lead Haskins & Sells to make any change in its certificate or its letter of transmittal?

A. If they had not cured the default we would have mentioned it in the certificate.

The letter of the president of Eastern Utilities Investing Corporation and the annual report for the year 1932 <sup>754</sup> were not transmitted

<sup>748</sup> C. A. Dougherty, an employee, was made president to succeed H. C. Hopson, at the time when Eastern Utilities Investing Corporation was definitely becoming involved in financial difficulties and in a precarious financial condition.

<sup>749</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3771, Part I.

<sup>750</sup> Reference to the other provisions eliminated was merely by paragraph number which meant nothing to most debenture holders because they had no copy of the indenture. The trustee, who had only one or two copies of the indenture, when requested by debenture holders to furnish them with copies, informed these holders that the indenture could be examined at its office or would refer them to the issuing company.

<sup>751</sup> Op. cit. supra, note 6, at 24289-90.

<sup>752</sup> Id., at 25218-9.

<sup>753</sup> Id., at 24291.

<sup>754</sup> Id., Commission's Exhibit No. 3771, Part I, annual report of Eastern Utilities Investing Corporation for the year 1932 containing letter of the president of that corporation to the security holders dated September 9, 1933.

to the security holders until September 9, 1933. This letter created the inference that the amendment to the indenture was an achievement entirely to the advantage of the debenture holder. The statement by the president that 85% of the outstanding debentures were represented and that only \$25,000 principal amount was voted against the adoption of the amendment, although true, was evidently designed to lull the debenture holders into the belief that the amendment must have been approved by many public holders and therefore must have been for the best interests of all debenture holders.<sup>755</sup>

Moreover, after the indenture had been amended so as to eliminate all the protective provisions, the management of Eastern Utilities Investing Corporation, commencing with the year 1933 and continuing thereafter until the company went into reorganization under Section 77B of the Bankruptcy Act in October 1936, failed to furnish their security holders with any balance sheet, profit-and-loss account, or portfolio list, despite the fact that Haskins & Sells, the company's auditors, had supplied audits to the management for these years.<sup>756</sup>

The advantages to the debenture holders, had their rights been enforced in September 1931, when an investigation would probably have disclosed a default, or in January 1932, when a default existed, according to Haskins & Sells, are, of course, conjectural. However, the fact is that the provisions which apparently were designed to protect the debenture holder by giving him a substantial margin of safety in a declining market, were never invoked and the Eastern Utilities Investing Corporation wound up in reorganization proceedings under Section 77B of the Bankruptcy Act in October 1936. Had the trustee taken affirmative action on the basis of the information and warnings it received on many occasions prior to April 1933, or had it ascertained the nature and value of the company's portfolio, the interests of the debenture holders might have been protected. The margin of safety of the 150% asset coverage and 125% asset coverage provisions might not have been so far reduced and the position of the debenture holders might not have been so hopeless.

Although this 77B proceeding was technically instituted for the reorganization of the company, in reality the plan contemplated liquidation of the company by means of an offer to remaining minority security holders to exchange their securities for securities of Associated Gas and Electric Company.<sup>757</sup>

Illustrative of the helplessness of the small debenture holders was the case of a woman holder of a \$1,000 debenture of the Eastern Utilities Investing Corporation who was in complete ignorance as to the significance of all the proceedings for amendment of the indenture, and yet who indicated that she had a very definite feeling that something was amiss. She resolved her confusion by refraining from voting.<sup>758</sup>

In contrast, The Tradesmens National Bank & Trust Company, of Philadelphia, mindful of its rights and refusing to accede without vigorous protest to the actions of the control interests at the meeting of the debenture holders, during the same year received from Eastern Utilities Investing Corporation (or associates) \$20,000 principal

<sup>755</sup> The proxy of Associated Gas and Electric Company also voted \$17,000 principal amount of debentures in the name of six holders.

<sup>756</sup> *Op. cit. supra*, note 6, Commission's Exhibit No. 3771, Part IV, Item 25.

<sup>757</sup> *Id.*, Commission's Exhibit No. 3783.

<sup>758</sup> *Id.*, Commission's Exhibit No. 3782, Item 8.

amount of Rochester Gas & Electric Corporation general mortgage 5% gold bonds due March 1, 1962, Series E, which were selling at about \$920 per \$1,000,<sup>759</sup> in payment for the bank's holdings of \$25,000 of debentures of Eastern Utilities Investing Corporation.<sup>760</sup> Based on market quotations, The Tradesmens National Bank & Trust Company received a bond selling at 92 when the debentures were quoted at 121½-141¼.<sup>761</sup> At that time, the exchange offer being made to the general public holders of Eastern Utilities Investing Corporation debentures was of debentures of Associated, which sold three months later, at the year end, at \$11 or \$12 for each \$100 of principal amount.<sup>762</sup>

### **J. Reacquisition of Preferred and Other Stocks of Eastern Utilities Investing Corporation**

Simultaneously with its program of acquisition of the Eastern Utilities Investing Corporation debentures, the Associated Gas & Electric System had pressed with equal vigor an exchange program for the capital stock securities of Eastern Utilities Investing Corporation held by the public. Both these programs, designed to eliminate any public interest in both the debentures and the capital stock of Eastern Utilities Investing Corporation, were not discontinued even after Eastern Utilities Investing Corporation went into reorganization proceedings under Section 77B of the Bankruptcy Act in October 1936.

The techniques employed by the Associated Gas & Electric System to induce holders of the securities of Eastern Utilities Investing Corporation to make exchanges is apparent from the various circulars issued by subsidiary companies. Although the protective features of the indenture underlying the Eastern Utilities Investing Corporation debenture issue were not enforced and were ultimately eliminated by amendment, the existence of these features was utilized by the "System" to persuade the Eastern Utilities Investing Corporation capital stock holders to switch these securities for securities of other companies in the "System."

On the one hand, the protective provisions contained in the indenture underlying the debentures were emphasized in the solicitation of exchanges of the capital stock of Eastern Utilities Investing Corporation for other securities of the "System." It was stressed that dividend payments could not be made on these stocks because of the debenture protective features and their exchange for the other securities was urged on this ground. On the other hand, the debenture holders were urged to eliminate these protective features in order to obviate liquidation of the company at a time when a market upturn was ostensibly anticipated by the management.<sup>763</sup> As early as November 12, 1931, Associated Gas and Electric Securities Company,

<sup>759</sup> This was the last sale price on November 18, 1933.

<sup>760</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3841.

<sup>761</sup> Id., Commission's Exhibit No. 3824.

<sup>762</sup> Id., Commission's Exhibit No. 3772, Items 19 and 38. See also supra and *Commercial & Financial Chronicle* and *National Bond Summary*.

<sup>763</sup> Id., Commission's Exhibit No. 3772, Item 39 (letter dated May 12, 1933, to debenture holders).

Inc., a subsidiary of Associated Gas and Electric Company, in a circular letter which explained the protective provisions of the indenture securing the debenture issue, implied that the demoralization of security markets imperiled even the debentures:<sup>764</sup>

Should the value of the assets go below 125% of the amount of the Debentures outstanding an event of default would occur and the principal of all the Debentures then outstanding, together with accrued and unpaid interest thereon, may by the Trustee be declared to be forthwith due and payable.

When the 5% debentures of the Company were first issued, no such depression in the market value of securities as now exists was anticipated by anyone and inserting these protective clauses in the Indenture materially improved the price at which they could be sold: at the present time their presence in the Indenture makes it unlikely, unless there is a radical improvement in security values, that further cash dividends can be declared for some time.

In view of the complete demoralization of security markets, we consider this an undesirable situation and urge that holders of preferred stock of Eastern Utilities Investing Corporation give serious consideration to the offers made below.

It has, therefore, been decided to offer the holders of Prior Preferred stock of Eastern Utilities Investing Corporation, the privilege of exchange their holdings and for each share received, either—

(a) \$100 principal amount of Associated Gas and Electric Company 5% convertible Certificates (convertible at the option of the Company into one share of its \$5 Dividend Preferred Stock), or

(b) \$50 principal amount of Gold Debenture Bonds, Consolidated Refunding 4½% Series due 1958, of Associated Gas and Electric Company and \$50 principal amount of its 5% Convertible Certificates.

On May 31, 1932, the holders of prior preferred stock of Eastern Utilities Investing Corporation were offered for each share of this stock either (a) \$100 principal amount Associated Gas and Electric Company 5% convertible obligations of 1932; or (b) one share of Associated Gas and Electric Company \$5 Dividend Series preferred stock into which the 5% convertible obligations of 1932 were convertible at the option of the company.<sup>765</sup>

The General Finance Corporation on September 26, 1932, offered \$100 principal amount of Associated Gas and Electric Company 5% convertible obligations Series A for each share of the Eastern Utilities Investing Corporation \$5 prior preferred stock. The letter containing this offer stated:<sup>766</sup>

At the present time interest on the Associated Gas and Electric Company 5% convertible obligations, Series A, is being paid in cash.

The letter then proceeded to point out that cash dividends on Eastern Utilities Investing Corporation \$5 preferred stock had been discontinued; and that by reason of the protective provisions of the indenture underlying the debentures, little likelihood existed that dividends could be resumed for a considerable period of time.

The efficacy of the provisions in the indenture was assumed and emphasized in order to induce exchanges of the securities which were junior to the debentures; while these same provisions in the indenture

<sup>764</sup> Id., Commission's Exhibit No. 3772, Item 40.

<sup>765</sup> Ibid.

<sup>766</sup> Ibid.

never were given their intended effect and ultimately were completely eliminated by Associated Gas and Electric Company through amendment to the indenture.

On December 9, 1932, The General Finance Corporation announced the proximity of the termination date of its offers to the holders of preferred and preference stocks of Eastern Utilities Investing Corporation, stating:<sup>767</sup>

The desirability of exchanging a stock such as that now held by you, upon which dividends are not being paid currently and cannot be paid by reason of indenture restrictions, until there has been a complete change upwards of the market value of all securities, for a security upon which interest is still being regularly paid (although its continuity cannot of course be unqualifiedly guaranteed in view of the present state of business), would appear to be obvious.

The exchange which has been offered is, we believe, a fair one, and the period of time in which it has been open has given all stockholders ample opportunity to take advantage of it. Those who still intend to accept the offer should do so immediately, as the remaining time is short.

On June 23, 1933, two days after the vote amending the indenture, The General Finance Corporation, in offering New England Gas and Electric Association \$5.50 dividend Series Preferred Shares in exchange for the prior preferred stock of Eastern Utilities Investing Corporation on a share-for-share basis, depicted the financial condition of Eastern Utilities Investing Corporation in the following language:<sup>768</sup>

As you undoubtedly know, Eastern Utilities Investing Corporation did not meet the interest payment due March 15, 1933, on its 5% Gold Debentures due 1954. It is over a year since dividends have been paid on its Prior Preferred Stock. In view of the existing default under the Indenture securing the debentures of Eastern Utilities Investing Corporation, there is a possibility of a foreclosure and liquidation of the Company, which we believe would not prove to be advantageous to the interests of its security holders.

This offer disclosed the debentures were in default, although Haskins & Sells justified their omission of reference to a default from their certificates on the ground the default had been cured.<sup>769</sup> The amendment had prevented enforcement of the default under the asset coverage provisions. That default had existed during 1932, the year to which the audit applied. But though the audit report for 1932 was not finally submitted until June 30, 1933, and the annual report of the company was not published until September 9, 1933, neither mentioned the fact that the debentures were in default for nonpayment of interest on March 15, 1933,<sup>770</sup> except that the president's letter of September 9, accompanying the annual report referred to nonpayment of interest in the following words:<sup>771</sup>

The discontinuance of cash interest on the Associated Gas and Electric Company Convertible Obligations held by the Corporation was the principal cause of the failure to provide for the payment of interest due March 15, 1933, on the debentures of this Corporation.

<sup>767</sup> Ibid.

<sup>768</sup> Ibid.

<sup>769</sup> Op. cit. supra, note 46, at 655-8.

<sup>770</sup> Op. cit. supra, note 6, Commission's Exhibits No. 3771, Part I, and No. 3780-D.

<sup>771</sup> Id., Commission's Exhibit No. 3771, Part I.

Resumption of dividends was held out by The General Finance Corporation as an inducement to accept the exchange: <sup>772</sup>

The exchange of shares tendered will be effected without adjustment of dividends so that those making the exchange will be entitled to the accrued dividends on the New England Gas and Electric Association Preferred Shares, without charge.

By July 25, 1933,<sup>773</sup> "less than 1/2 of 1% of the total amount of the \$5 Prior Preferred Stock of Eastern Utilities Investing Corporation originally issued" was still outstanding in the hands of the general public and The General Finance Corporation again extended the time for acceptance of its original offer.

On May 31, 1934, that same offer was further extended to June 20, 1934, when it was to expire. However, on July 27, 1934, The General Finance Corporation stated: <sup>774</sup>

Less than 2/10ths of 1% of the original amount of the \$5 Prior Preferred Stock of Eastern Utilities Investing Corporation, owned by only 26 holders, is still outstanding in the hands of the general public \* \* \*. In liquidation of the Corporation, your stock would undoubtedly be of no value.

Again pointing out that New England Gas and Electric Association \$5.50 Dividend Series Preferred Shares have regularly paid their dividends in cash, The General Finance Corporation stated:

We hope you will appreciate that in again bringing this offer to your attention we are actuated more by the desire that the small remaining holders who have not yet acted shall not be discriminated against as compared with the great number who have, than we are by any desire on our part to acquire their stock. The few remaining shares outstanding have little or no value, even from a nuisance standpoint. Liquidation of the corporation is undoubtedly desirable and entirely practicable regardless of whether or not the remaining shares of its stock are exchanged.

On August 21, 1934, the public held only small interests in each of the classes of securities issued by Eastern Utilities Investing Corporation: <sup>775</sup>

Security:	<i>Percent in the hands of the general public</i>
\$7 preferred-----	0.9
\$6 preferred-----	0.1
\$5 prior preferred-----	0.1
Participating preference-----	0.1
5% debentures due 1954-----	3.9
Class A common stock-----	6.7

The General Finance Corporation, in an attempt to clean up these small outside holdings, in a letter dated August 21, 1934, stated to the holders of prior preferred stock of Eastern Utilities Investing Corporation: <sup>776</sup>

<sup>772</sup> Id., Commission's Exhibit No. 3772, Item 40.

<sup>773</sup> Ibid.

<sup>774</sup> Ibid.

<sup>775</sup> Ibid. (and also Item 44).

<sup>776</sup> Ibid.

There is no question but that the stock offered to you in exchange has a value and a good market and the offer is, therefore, entirely out of line as compared to your security, yet we hesitate to definitely cut off the opportunity for you to make this advantageous exchange, namely New England Gas and Electric Association \$5.50 Dividend Series Preferred Shares on a share-for-share basis, until we are sure that the few remaining holders are thoroughly familiar with the situation.

In the same letter, The General Finance Corporation blamed the drop in the asset value coverage of the debentures from about \$2,200 to \$70 entirely on the depression and other conditions, saying:

When Eastern Utilities Investing Corporation sold its 5% Debentures due 1954, a few months before the break in the market in 1929, the prospects for the future of investment companies were very favorable. This was especially true of investment companies whose portfolios were concentrated in public-utility equity securities which were so popular at that time. What has happened since then to all investments is familiar to you. The unprecedented decline in all security values has been due to a world-wide depression which could not be foreseen and which has drastically curtailed earnings applicable to equity securities. In addition to these universal conditions, the public-utility industry in the United States has faced increased taxes, governmental competition, decreased rates, and more recently higher operating costs, due to N. R. A.

\* \* \* \* \*

The result of the adverse business and economic forces, briefly referred to above, has brought about a decline in the value of the securities now owned by the Corporation so that its debentures now have an asset value of scarcely \$70 per \$1,000 debenture.

The General Finance Corporation then emphasized the fact that there was no equity left for the preferred, preference, and common stocks of the Eastern Utilities Investing Corporation, and stated:<sup>777</sup>

You might well ask why we are willing to give you a much better security in exchange for the one which you hold. The answer is that the amount already invested in this situation by affiliated interests is now so large that there is no alternative left for them but to remain with it in order to work out the liquidation of the corporation. They hope the cost of voluntary liquidation in this manner will be less than forced liquidation through court procedure, and, of course, the liquidation of this corporation will materially assist in simplifying the remaining complexity in the Associated System.

There is, of course, some possibility that the portfolio of the Corporation may again become of value. This, however, is not only dependent upon the general course of business, but what we think is even more important, a reversal of business sentiment toward the utility industry and also the ability of Associated Gas and Electric Company (whose junior securities constitute a principal part of the portfolio) to withstand the effect of these disadvantageous influences pending a general change in the political attitude toward the industry. Obviously, the value of the securities in the investment portfolio of Eastern Utilities Investing Corporation is such a small portion of the face amount of its debentures that its junior securities \* \* \* have no present value, and the only value which we might properly assign to them is the amount which may result from the saving of large expenses which perhaps otherwise may have to be incurred in connection with the liquidation of the Corporation.

<sup>777</sup> Ibid.



### K. Institution of 77B Proceedings in Bankruptcy

Eastern Utilities Investing Corporation, on October 14, 1936, filed with the Federal Court in Delaware a voluntary petition in bankruptcy under Section 77B of the Bankruptcy Act. Attached to this petition was a plan of reorganization already accepted by Associated Gas and Electric Company and one of its subsidiaries as the holders of a majority of each class of securities issued by the petitioning debtor, Eastern Utilities Investing Corporation. All of the voting stock of Eastern Utilities Investing Corporation was held by Associated Gas and Electric Company. Briefly, the plan of reorganization and the amended plan which was later confirmed provided for the transfer of all the debtors' assets to Associated Gas and Electric Company and in consideration therefor the issuance of Associated Gas and Electric Company securities to the security holders of Eastern Utilities Investing Corporation, the debtor.<sup>778</sup>

Mr. Stix, general auditor for the Associated System and formerly comptroller of Eastern Utilities Investing Corporation, claimed that Eastern Utilities Investing Corporation was put into 77B proceedings in order to compel its remaining public security holders to exchange their securities for Associated Gas and Electric Company securities as most of the others had done pursuant to the program of exchange offers sponsored by Associated Gas and Electric Company.<sup>779</sup>

At the time of the filing of the petition the officers and directors of Eastern Utilities Investing Corporation consisted of three individuals employed in routine capacities by the Associated System and who reported to the head of Associated's general office in Wilmington, Delaware. These individuals continued to perform their usual duties for the Associated System and, as S. C. Stackhouse, the individual who was designated president and a director, expressed it, were only "to sit on the assets"<sup>780</sup> of Eastern Utilities Investing Corporation. Mr. Stackhouse, who had been designated a director on January 2, 1936, and president on March 13, 1936, was not familiar with the history of the company's investments.<sup>781</sup> However, he did nothing more than to ascertain that Eastern Utilities Investing Corporation was inactive and in process of liquidation and to ask Mr. Stix for instructions with respect to the company.<sup>782</sup> Mr. Stix suggested that he consult with Mr. Lepine, of the law firm of Travis, Brownback & Paxson,<sup>783</sup> whom the president of Eastern Utilities Investing Corporation knew to be counsel for the Associated Gas & Electric System.<sup>784</sup> The president did not in anywise participate in the formulation of the plan of reorganization except to check the printer's proofs thereof for typographical errors and to return them either to Mr. Lepine or to the Associated's New York office, where he assumed that the plan had been drafted. He did not know who worked out the plan. He stated that he was not experienced in finan-

<sup>778</sup> Id., at 26274 and Commission's Exhibits Nos. 3783 and 3784.

<sup>779</sup> Op. cit. supra, note 41, at 403.

<sup>780</sup> Op. cit. supra, note 46, at 235.

<sup>781</sup> Id., at 223, 225-6.

<sup>782</sup> Id., at 235, 261.

<sup>783</sup> Id., at 247.

<sup>784</sup> Ibid.

cial affairs or corporate reorganizations, but he was familiar with securities of the Associated System, having been "next door to the accounting department for thirteen or fourteen years."<sup>785</sup>

The plan was approved by the board of directors of Eastern Utilities Investing Corporation, entirely composed of these three employees of the Associated System, and was recommended to the security holders.

The New York Trust Company, the trustee, was not permitted to participate in the 77B proceedings. In October 1936, Messrs. Miller, Owen, Otis & Bailly had resigned as counsel for the New York Trust Company, trustee, because of the possible conflict arising out of their representation, as co-counsel, subsequent to 1933, of the Associated Gas and Electric Company in reorganization proceedings under Section 77B of the Bankruptcy Act.<sup>786</sup> On the advice of its new counsel, Messrs. Humes, Buck, Smith, and Stowell, the trustee endeavored to obtain permission of the Court to intervene in the 77B proceedings of Eastern Utilities Investing Corporation and to file objections and comments on the plan of reorganization submitted by the management. However, the permission in each case was denied by the Court.

The counsel who appeared for Eastern Utilities Investing Corporation in the bankruptcy proceedings, as well as at the public examination before this Commission, were the usual counsel of the Associated Gas & Electric System.<sup>787</sup> The plan provided for the payment of counsel fees by Associated Gas and Electric Company, although the president of Eastern Utilities Investing Corporation did not know who inserted that provision in the plan.<sup>788</sup> When the Department of Justice of the United States Government, on behalf of the Internal Revenue Bureau, requested the Court to appoint a trustee for Eastern Utilities Investing Corporation on the ground that the Associated management had depleted the assets of Eastern Utilities Investing Corporation and that an independent trustee would vigorously investigate this depletion, the counsel for Eastern Utilities Investing Corporation, who were also counsel for the Associated System, denied that there had been such abuses and objected to the appointment of a trustee.<sup>789</sup> The president of Eastern Utilities Investing Corporation was present at the hearing when these charges and denials were made. But, although he did not know whether they were true or false, he accepted the advice of the aforementioned counsel and permitted them to oppose the appointment of the trustee. He stated that "he did not recall how it came about" that they opposed the appointment of a trustee.<sup>790</sup> He knew that counsel for the company of which he was president also represented the Associated System and that the charges of misfeasance were being made against the Associated System. Mr. Burroughs and Mr. Stix were two of the individuals in the Associated management who had been charged with participation in the perpetration of the abuses. However, the president accepted the advice of these individuals and that of counsel

<sup>785</sup> *Id.*, at 297.

<sup>786</sup> *Id.*, Commission's Exhibit 3782, Item 106.

<sup>787</sup> *Id.*, at 247.

<sup>788</sup> *Op. cit. supra*, note 6, Commission's Exhibit No. 3783.

<sup>789</sup> *Op. cit. supra*, note 46, at 245.

<sup>790</sup> *Id.*, at 241.

who acted for the Associated Gas & Electric System as well as for Eastern Utilities Investing Corporation, and stated that there seemed to be no need to investigate the truth of the charges.<sup>791</sup> The president admitted that he was personally too unfamiliar with the financial history of Eastern Utilities Investing Corporation to have an opinion as to the validity or falsity of the charges.<sup>792</sup>

R. T. Webster, secretary, treasurer, and one of the three directors of Eastern Utilities Investing Corporation, stated that although he had known for many months of the charges made in the Government's petition, he approved the opposition to an investigation of these charges. Mr. Webster testified:<sup>793</sup>

Q. You have been in favor of opposing any investigation into the charges made by the Government in its petition of January 10, 1938: is that right?

A. That is right.

Mr. Webster did not know whether the Government's charges were baseless and made no examination of the company's books to ascertain their accuracy. He did not know whether he ever discussed the charges with Mr. Stackhouse, the president, or with any other person,<sup>794</sup> but he opposed the investigation because of his contact with Mr. Stackhouse, who had "consulted with counsel" (Messrs. Travis, Brownback & Paxson), Mr. Stix, and other members of the Associated organizations.<sup>795</sup> Mr. Webster stated he was not interested in having the company enforce any cause of action which might be contained in the Government's petition.<sup>796</sup> He knew that the debtor's counsel were also counsel for the Associated System, but he did not think that there was any conflict of interest between the debtor and the Associated Gas & Electric System.<sup>797</sup>

Nevertheless, despite this opposition, the United States District Court for the District of Delaware appointed a trustee for Eastern Utilities Investing Corporation and later, upon petition of the United States Attorney for the District of Delaware, alleging—

\* \* \* that an investigation \* \* \* reveals what are believed to be valid claims and causes of action which, if successfully prosecuted, would result in the recovery of additional assets of substantial value for the estate of [Eastern Utilities Investing Corporation],

ordered an—

examination pursuant to Section 21 (a) of the Bankruptcy Act, as amended, concerning the acts, conduct, or property of the debtor \* \* \*.<sup>798</sup>

Such examinations were held<sup>799</sup> and were still pending in July 1939, when the Associated Gas & Electric System agreed to settle the controversy over its federal income taxes, including those of Eastern

<sup>791</sup> Id., at 271 and 273.

<sup>792</sup> Id., at 272.

<sup>793</sup> Id., at 409.

<sup>794</sup> Id., at 413.

<sup>795</sup> Id., at 410, 413.

<sup>796</sup> Id., at 414.

<sup>797</sup> Id., at 385.

<sup>798</sup> *Eastern Utilities Investing Corporation, Appellants, v. United States of America, Appellees*, United States Circuit Court of Appeals for the Third Circuit, March term, 1938. (transcript of record on appeal from the District Court of the United States for the District of Delaware).

<sup>799</sup> See note 46, *supra*.

Utilities Investing Corporation. A stipulation was signed withdrawing the tax claims.<sup>800</sup>

And on August 3, 1939, Judge John P. Shields signed a final decree in the aforementioned proceedings under Section 77B of the Bankruptcy Act, directing the consummation of the amended plan of reorganization. The amended plan provides that the various securities of Eastern Utilities Investing Corporation be exchanged for securities of Associated Gas and Electric Company and that legal and trustee fees be paid.<sup>801</sup> In view of the closing of the estate, the examinations under Section 21A of the Bankruptcy Act, into the conduct of those in control of Eastern Utilities Investing Corporation, closed.

### L. Investors' Experience

The debentures of Eastern Utilities Investing Corporation in the principal amount of \$35,000,000 were offered to the public at a price of 98 in March 1929. On this basis the public invested \$33,385,660 of cash in the \$34,067,000 principal amount of debentures which had been reacquired by the Associated Gas & Electric System as at December 31, 1935.<sup>802</sup> In return for these debentures which the public relinquished, the "System" gave cash of \$987,362 and securities having a market value of \$8,281,093 as at December 31, 1935, or a total consideration of \$9,268,455<sup>803</sup> based on market prices at that date. Conse-

<sup>800</sup> In the matter of *Eastern Utilities Investing Corporation*, debtor, No. 1247, in Bankruptcy, in the United States District Court for the District of Delaware. (Op. cit. supra, note 46.) One tax claim, that for the year 1926, was secured by a cash deposit pending disposition. (Ibid., and *Wall Street Journal*, August 4, 1939.) Under the decree, Thomas F. Bayard, Trustee in the Bankruptcy Proceedings, is to receive a fee of \$10,000; Joseph M. Hartfield, counsel for said trustee, is to receive \$25,000; and \$15,000 is to be paid Richardson, Layton & Finger, local attorneys who appeared for Eastern Utilities Investing Corporation in the proceedings.

<sup>801</sup> On January 10, 1940, within 6 months of the decree directing consummation of the plan of reorganization whereby the security holder of the investment company received securities of Associated Gas and Electric Company in exchange, the latter company in turn filed a petition in bankruptcy in the United States District Court for the Northern District of New York.

<sup>802</sup> Op. cit. supra, note 6, Commission's Exhibit No. 3772, Item 19. These figures include \$131,000 principal amount reacquired directly by Eastern Utilities Investing Corporation in exchange for portfolio securities.

<sup>803</sup> Securities and cash received in exchange:

	As at Dec. 31, 1935		
	Principal amount	Market price	Market value
Cash.....			\$987,362
Associated Gas & Electric Co. 4½'s of 1949.....	\$16,716,000	27½	4,596,900
Associated Gas & Electric Co. 4½'s of 1958.....	9,143,100	28	2,560,068
Associated Gas & Electric Co. 4's of 1983.....	4,924,000	20	984,800
Associated Gas & Electric Co. 4½'s of 1948.....	10,000	28	2,800
Associated Gas & Electric Co. 5% conv. obligations.....	530,000	5	26,500
Utilities Power & Light Corporation 5% debentures due 1959.....	114,000	61	69,540
New England Gas & Electric Association 5's 1947.....	20,000	76	15,200
Rochester Gas & Electric Corporation 5's 1962.....	20,000	105½	21,125
Associated Gas & Electric 4% inc. deb. 1983.....	16,000	26	4,160
Total.....			9,268,455

Source: Op. cit. supra, note 6, Commission's Exhibit No. 3772, Item 19; market prices from *The New York Times*, *Commercial & Financial Chronicle*, and *National Bond Summary*.

quently the public investors in Eastern Utilities Investing Corporation debentures, who exchanged them pursuant to offers made by the "System," had by the end of 1935 suffered a loss of \$24,117,205, or over 72% of their original investment in the debentures.

At the end of 1935, \$933,000 principal amount of Eastern Utilities Investing Corporation debentures were still in the hands of the public. On the basis of the public offering price of 98, the sum of \$914,340 in cash had been paid by the public for these debentures which had a value of \$345,210 based on a bid price of 37 at the end of 1935.<sup>804</sup> Thus the investors who kept their Eastern Utilities Investing Corporation debentures lost \$569,130, or 62% of their original investment, exclusive of their loss of interest subsequent to October 15, 1932.

To show the effect of the dealings between Eastern Utilities Investing Corporation and the "System," it is significant to note that when the debentures were sold in March 1929, the assets were claimed to be more than \$2,200 per \$1,000 debenture,<sup>805</sup> and that on May 12, 1933, the assets were indicated to be only \$85 per \$1,000 debenture,<sup>806</sup> a drop of 96% in four years.

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<sup>804</sup> Bid price as of January 24, 1936, quoted in National Corporation Bond Summary.

<sup>805</sup> Commission's Exhibit No. 3771, Part 1.

<sup>806</sup> Commission's Exhibit No. 3772, Item 39.



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## Appendix A

### REFERENCES TO NEWSPAPER EDITORIALS CONCERNING INVESTMENT TRUSTS AND INVESTMENT COMPANIES

The following are references to some of the editorials concerning investment trusts and investment companies published in newspapers in various sections of the country during the course of the study and investigation by the Commission. References to news items have not been included.

#### *California*

Fresno :  
     Bee, August 13, 1936.  
     Bee, November 25, 1936.  
 Sacramento :  
     Bee, July 31, 1936.  
     Bee, August 18, 1936.  
 San Francisco : News, January 7, 1937.

#### *Colorado*

Colorado Springs : Gazette, August 18, 1936.

#### *Connecticut*

Danbury :  
     News, August 19, 1936.  
     News-Times, August 7, 1936.  
 Hartford : Courant, August 18, 1936.

#### *District of Columbia*

News, November 9, 1935.  
 News, September 19, 1936.  
 News, October 20, 1936.  
 News, December 29, 1936.  
 News, April 3, 1937.  
 News, April 20, 1937.  
 Post, August 2, 1936.  
 Post, December 19, 1936.  
 Post, June 9, 1938.  
 Post, September 25, 1938.

#### *Florida*

Miami : Herald, October 14, 1938.

#### *Idaho*

Lewiston : Tribune, August 20, 1936.

#### *Indiana*

Indianapolis : Star, August 5, 1936.  
 South Bend : Tribune, August 19, 1936.

#### *Iowa*

Sioux City : Tribune, November 19, 1936.

#### *Kentucky*

Louisville : Courier Journal, July 31, 1936.

#### *Louisiana*

Shreveport : Times, August 19, 1936.

#### *Maryland*

Baltimore : Evening Sun, August 13, 1936.  
 Hagerstown : Mail, October 26, 1936.

#### *Massachusetts*

Boston : Christian Science Monitor, July 30, 1936.

#### *Michigan*

Kalamazoo : Gazette, August 14, 1936.  
 Saginaw : News, August 12, 1936.

#### *Missouri*

St. Louis :  
     Post-Dispatch, August 8, 1936.  
     Post-Dispatch, August 13, 1936.  
     Post-Dispatch, August 21, 1936.  
     Post-Dispatch, January 4, 1937.  
     Times, September 8, 1936.

#### *Montana*

Great Falls :  
     Tribune, August 7, 1936.  
     Tribune, August 9, 1936.  
     Tribune, June 5, 1938.  
 Helena :  
     Independent, August 15, 1936.  
     Independent, November 5, 1936.

#### *New Jersey*

Camden : Courier, November 12, 1936.  
 Newark :  
     News, July 22, 1936.  
     News, November 13, 1936.  
 Trenton : Gazette, December 4, 1936.



*New Mexico*

Albuquerque: Journal, August 10, 1936.

*New York*

Buffalo:

Courier Express, July 28, 1936.

Courier Express, August 18, 1936.

Elmira: Star-Gazette, November 13, 1936.

New York:

Evening Post, January 23, 1936.

Evening Post, November 12, 1936.

Evening Post, November 13, 1936.

Journal of Commerce, January 22, 1936.

Journal of Commerce, July 28, 1936.

Journal of Commerce, October 1, 1936.

Journal of Commerce, December 26, 1936.

Journal of Commerce, June 10, 1938.

Journal of Commerce, February 2, 1939.

Times, July 30, 1938.

Times, September 23, 1938.

Wall Street Journal, September 18, 1936.

Wall Street Journal, January 11, 1937.

Wall Street Journal, October 22, 1938.

Wall Street Journal, September 23, 1938.

World-Telegram, November 11, 1935.

Syracuse: Post-Standard, July 29, 1936.

Troy: Times Record, July 24, 1936.

*North Carolina*

Raleigh: News and Observer, August 17, 1936.

*Ohio*

Columbus: Citizen, September 19, 1936.

Dayton: News, June 3, 1938.

*Oregon*

Portland: Oregonian, August 15, 1936.

*Pennsylvania*

Altoona: June 4, 1938.

Chester: Times, August 20, 1936.

Easton: Express, August 21, 1936.

Philadelphia:

Bulletin, January 11, 1937.

Inquirer, November 26, 1936.

Record, January 27, 1936.

*South Carolina*

Greenville:

News, July 29, 1936.

News, October 6, 1936.

*Texas*

El Paso: Times, December 6, 1936.

Fort Worth:

Press, November 9, 1935.

Star Telegram, July 30, 1936.

Star Telegram, August 19, 1936.

Houston: Press, October 20, 1936.

*Washington*

Spokane: Spokesman-Review, August 19, 1936.

*Wisconsin*

Green Bay: Press Gazette, August 15, 1936.

Milwaukee:

Journal, November 25, 1936.

Journal, December 1, 1936.

## Appendix B

TRANSACTIONS OF WALLACE GROVES IN THE SHARES OF COMMON STOCK OF INTERSTATE EQUITIES CORPORATION, CHAIN & GENERAL EQUITIES, INC., YOSEMITE HOLDING CORPORATION AND THE EQUITY CORPORATION INVOLVED IN HIS ACQUISITION OF CONTROL OF SUCH COMPANIES, SHOWING ALSO HIS DISPOSITION OF SUCH SHARES AND RESULTANT PROFIT OR LOSS

Date of commitment of purchase	Date of actual payment	Number of shares purchased and source of purchase	Purchase price per share	Total purchase price	Total cost	Source of funds with which to meet purchase commitment	Date of actual sale	Number of shares sold	Purchaser	Sale price per share	Total sales price	Profit or (loss)
Interstate Equities Corporation common stock												
Sept. 30, 1931.	Oct. 8, 1931.	542,517 (Bancamerica-Blair)	\$1.50	\$813,775.50		Loan from Franklin Plan of \$813,000.						
Sept. 30, 1931.	Nov. 5, 1931.	100,000 (Hunter Marston)	1.50	150,000.00	\$1,053,964.28	Sale to Chain & General of Interstate Equities common stock.	Nov. 4, 1931.	642,517	Chain & General.	\$2.062	\$1,325,034.00	\$271,069.72
Oct. 14, 1931.	Jan. 21, 1932.	12,000		18,000.00	18,000.00		Jan. 23, 1932.	12,000	Chain & General Equities.	1.25	15,000.00	(3,000.00)
Chain & General Equities, Inc. common stock												
Sept. 23, 1931.	Nov. 4, 1931.	467,938 (Chain & General)	2.00	935,876.00	935,876.00	"Loan" from Interstate Equities of \$935,876.	Nov. 16, 1931.	231,158	Yosemite Holding.	2.38	550,000.00	\$7,684.00
							Nov. 16, 1931.	236,780	Franklin Plan.	2.40	568,272.00	94,712.00
									Net profits realized to Jan. 23, 1932.			450,465.72
	Mar. 24, 1932.	41,780 (Franklin Plan)	2.40	100,272.00	100,272.00	Simultaneous sale to Yosemite Holding of shares purchased.	Mar. 24, 1932.	41,780	Yosemite Holding.	2.38	99,436.40	(835.60)
	June 30, 1932.	46,219 (Franklin Plan)	2.40	110,925.60	110,925.60	do	June 30, 1932.	46,219	do	2.38	110,001.22	(924.38)
Sept. 29, 1933.	September 1933. Apr. 24, 1934.	147,031 (Franklin Plan trustee)		100,000.00 12,500.00	100,000.00 12,500.00		Apr. 24, 1934.	147,031	U. S. Shares Corporation (Maryland).			(112,500.00)
		Subtotal			2,331,537.88						2,667,743.62	336,205.74

**TRANSACTIONS OF WALLACE GROVES IN THE SHARES OF COMMON STOCK OF INTERSTATE EQUITIES CORPORATION,  
CHAIN & GENERAL EQUITIES, INC., YOSEMITE HOLDING CORPORATION AND THE EQUITY CORPORATION INVOLVED  
IN HIS ACQUISITION OF CONTROL OF SUCH COMPANIES, SHOWING ALSO HIS DISPOSITION OF SUCH SHARES  
AND RESULTANT PROFIT OR LOSS—Continued**

Date of com- mitment of purchase	Date of actual payment	Number of shares purchased and source of purchase	Pur- chase price per share	Total pur- chase price	Total cost	Source of funds with which to meet purchase commitment	Date of actual sale	Num- ber of shares sold	Purchaser	Sale price per share	Total sales price	Profit or (loss)
Yosemite Holding Corporation common stock												
Oct. 7, 1931	Nov. 5, 1931	282,500 (Yosemite Holding).	\$1.00	\$282,500.00	b\$363,356.29	{Sale to Chain & General of Inter- state Equities common stock.						
	Nov. 6, 1931	10,000 (Yosemite Holding).	1.00	10,000.00								
	To Dec. 9, 1932.	35,032 (Market and Yosemite).	1.00	35,032.00								
		Subtotal		c 327,532 shs	398,388.29							
The Equity Corporation common stock												
	Dec. 9, 1932	1,150,000			398,388.29		May 26, 1933	1,000,000	Oceanic Ins. Co.	\$0.90	\$900,000.00	\$553,575.40
							May 1934	75,000	Oceanic Ins. Co. and/or Chase Donaldson.	1.00	75,000.00	49,018.15
							August 1934	75,000	Oceanic Ins. Co.	1.00	75,000.00	49,018.16
		Grand total							Subtotal		1,050,000.00	651,611.71
					2,729,926.17				Grand total		3,717,743.62	987,817.45

a Commissions and expenses, \$90,188.78.

b Commissions and expenses, \$70,856.29.

c These 327,532 shares of Yosemite Holding Corporation common stock were exchanged on or about Dec. 9, 1932, for shares of The Equity Corporation common stock.

## Appendix C

### LIST OF PREFERRED SUBSCRIBERS TO STOCK OF PETROLEUM CORPORATION OF AMERICA AT LESS THAN THE OFFERING PRICE

Name of purchaser	Principal business association of purchaser *	Relation to Petroleum Corporation	Number of shares
George Armsby.....	Blair & Co., Inc.....	Director.....	5, 000
Jules Bache.....	J. S. Bache & Co.....	do.....	5, 000
R. K. Ballard.....	Director, Blair & Co., Inc.....	None.....	600
Georges Benard.....	do.....	do.....	1, 000
Harry Bronner.....	Blair & Co., Inc.....	Director.....	5, 000
W. Frank Carter.....	Carter, Jones & Turney.....	do.....	1, 000
T. L. Chadbourne.....	Chadbourne, Stanchfield & Levy.	do.....	5, 000
E. H. Clark, Jr.....	Vice president, Blair & Co., Inc.	None.....	500
Wm. G. Costin.....	Chairman, Pittsburgh Screw & Bolt Co.	Director.....	15, 000
Ruloff E. Cutten.....	E. F. Hutten & Co.....	do.....	5, 000
A. H. Diebold.....	President, Drug, Inc.....	do.....	5, 000
Garretson Dulin.....	Hunter, Dulin & Co.....	do.....	2, 000
Fred Ecker.....	Vice president, Metropolitan Life Insurance Co.		5, 000
Henry W. Farnum.....	Farnum, Winter & Co.....	Director.....	5, 000
F. F. Florence.....	Vice president, Republic National Bank, Dallas, Tex.	do.....	5, 000
J. Grant Forbes.....	Director, Blair & Co., Inc.....	None.....	1, 000
P. A. S. Franklin.....	President, International Mercantile Marine Co.	Director.....	5, 000
Halstead G. Freeman.....	President, Chase Securities Corporation.	do.....	5, 000
T. M. Girdler.....	President, Jones & Laughlin Steel Corporation.	do.....	1, 000
P. G. Gossler.....	President, Columbia Gas & Electric Corporation.	do.....	5, 000
Joshua Green.....	Chairman, Peoples Bank & Trust Co., Seattle, Wash.	do.....	5, 000
John C. Grier, Jr.....	President, Guardian Detroit Co.	do.....	5, 000
R. E. Harding.....	Vice president, Fort Worth National Bank.	do.....	1, 500
F. T. Haskell.....	Director, Illinois Merchants Trust Co.	do.....	1, 000
E. F. Hayes.....	Director, Blair & Co., Inc....	None.....	1, 000
Louis W. Hill.....	Chairman, Great Northern Ry. Co.	Director.....	5, 000
E. F. Hutton.....	Chairman, Postum Co., Inc....	do.....	5, 000
W. R. Johnston.....	Vice president, Blair & Co., Inc.	None.....	500

\*At time of purchase,

**LIST OF PREFERRED SUBSCRIBERS TO STOCK OF PETROLEUM CORPORATION OF AMERICA AT LESS THAN THE OFFERING PRICE—  
Continued**

Name of purchaser	Principal business association of purchaser	Relation to Petroleum Corporation	Number of shares
Jones & Laughlin Steel Corporation.	-----	None-----	5, 000
C. Lewis-----	Director, Blair & Co., Inc.---	do-----	5, 000
G. N. Lindsay-----	do-----	do-----	500
Auther W. Loasby---	President, Equitable Trust Co., New York.	Director-----	5, 000
Henry Lockhart, Jr.---	Director, Blair & Co., Inc.---	None-----	5, 000
John G. Lonsdale---	President, National Bank of Commerce, St. Louis.	Director-----	3, 000
Walter S. McLucas---	Chairman, Commerce Trust Co., Kansas City, Mo.	do-----	5, 000
J. H. Markham, Jr.---	Capitalist-----	President and director.	5, 000
Hunter S. Marston---	Blair & Co., Inc.-----	Director-----	3, 000
Jean Mennet-----	Director, Blair & Co., Inc.---	None-----	500
Chas. A. Munroe-----	President, Northern Utilities Co.	Director-----	5, 000
Jansen Noyes-----	Hamphill, Noyes Co.-----	do-----	5, 000
Henry C. Olcott, Jr.---	Director, Blair & Co., Inc.---	None-----	500
P. H. O'Neil-----	Capitalist, Los Angeles-----	Director-----	5, 000
E. S. H. Pendergrast---	Director, Blair & Co., Inc.---	None-----	500
T. W. Phillips, Jr.---	Capitalist-----	Director-----	5, 000
E. A. Pierce-----	E. A. Pierce & Co.-----	do-----	2, 000
Alonzo Potter-----	Director, Blair & Co., Inc.---	None-----	500
Geo. F. Rand-----	President, Marine Trust Co. of Buffalo.	Director-----	5, 000
Earl H. Reynolds-----	President, Peoples Trust & Savings Bank of Chicago.	do-----	5, 000
H. H. Rogers-----	President, Exchange National Bank, Tulsa, Okla.	do-----	5, 000
L. P. Sheldon-----	Director, Blair & Co., Inc.---	None-----	1, 000
T. G. Smith-----	Vice president, Central Union Trust Co., New York.	Director-----	5, 000
Arnold G. Stifel-----	Stifel, Nicolaus & Co., Inc.---	do-----	5, 000
C. I. Stralem-----	Hallgarten & Co.-----	do-----	5, 000
E. R. Tinker-----	Capitalist, New York-----	do-----	5, 000
Geo. W. Treat-----	E. H. Rollins & Sons-----	do-----	1, 000
Nion R. Tucker-----	Bond & Goodwin & Tucker---	do-----	5, 000
Elisha Walker-----	President, Blair & Co., Inc.---	do-----	5, 000
Geo. Walker-----	Chairman, Executive Committee, Citizens National Trust & Savings Bank, Los Angeles.	do-----	2, 000
James C. Willson-----	James C. Willson & Co.-----	do-----	5, 000

## Appendix D

### DISTRIBUTION OF PROFITS TO THE PARTICIPANTS IN THE PRAIRIE SYNDICATE

	Participa- tion in group (percent)	Amount re- ceived
A. M. Andrews.....	1	\$57, 500. 00
Bancamerica-Blair Corporation.....	21. 75	1, 250, 625. 00
Chase Securities Corporation.....	14. 50	833, 750. 00
Continental National Corporation.....	4	230, 000. 00
Arthur W. Cutten.....	21. 75	1, 250, 625. 00
Equitable Trust Co. of New York.....	2	115, 000. 00
Famoth Corporation.....	1. 75	100, 625. 00
Haygart Corporation.....	. 50	28, 750. 00
Haystone Corporation.....	. 50	28, 750. 00
L. W. Hill.....	. 50	28, 750. 00
C. O. Kalman.....		
Arthur Reynolds.....	1	57, 500. 00
Shermar Corporation.....	7. 25	416, 875. 00
Harry F. Sinclair.....	21. 75	1, 250, 625. 00
The Traywin Corporation.....	1. 75	100, 625. 00

## Appendix E

### INTERLOCKING DIRECTORS: BANCAMERICA-BLAIR CORPORATION, SINCLAIR CONSOLIDATED OIL CORPORATION AND PETROLEUM CORPORATION OF AMERICA

Elisha Walker-----	Bancamerica-Blair-----	President, 1929. Chairman, 1930, 1931.
	Petroleum Corporation---	Chairman of Board, 1929, 1930, 1931, 1932. Board of Directors, 1929, 1930, 1931, 1932.
	Sinclair Consolidated Oil_	Board of Directors, 1929, 1930, 1931, 1932.
	Prairie Oil & Gas-----	Board of Directors, 1931.
	Hunter Marston---	Bancamerica-Blair-----
Hunter Marston---	Bancamerica-Blair-----	Vice president, 1929, 1930. President, 1930, 1931. Board of Directors, 1929, 1930, 1931.
	Petroleum Corporation---	Board of Directors, 1929, 1930, 1931, 1932.
	Sinclair-----	Board of Directors, 1932, 1933.
	Prairie Oil & Gas-----	Board of Directors, 1931.
	George Armsby---	Bancamerica-Blair-----
George Armsby---	Bancamerica-Blair-----	President, 1932. Vice president, 1929, 1930, 1931. Board of Directors, 1929, 1930, 1931.
	Petroleum Corporation---	Board of Directors, 1929, 1930, 1931, 1932, 1933.
	E. R. Tinker-----	Bancamerica-Blair-----
	Bancamerica-Blair-----	Chairman of Executive Com- mittee, 1930, 1931. Board of Directors, 1930, 1931.
	Petroleum Corporation---	Board of Directors, 1929, 1930, 1931, 1932, 1933.
E. R. Tinker-----	Sinclair-----	Board of Directors, 1929, 1930, 1931, 1932, 1933.
	Prairie Pipe-----	Board of Directors, 1931.
	Harry Bronner----	Bancamerica-Blair-----
	Bancamerica-Blair-----	Board of Directors, 1930, 1931.
	Petroleum Corporation---	Board of Directors, 1929, 1930, 1931, 1932.
A. W. Cutten-----	Petroleum Corporation---	Board of Directors, 1929, 1930, 1931.
	Sinclair-----	Board of Directors, 1929, 1930, 1931, 1932.
E. W. Sinclair-----	Petroleum Corporation---	Board of Directors, 1933.
	Sinclair-----	President, 1929, 1930, 1931. Chairman of Financial Com- mittee, 1932, 1933.
		Board of Directors, 1929, 1930, 1931, 1932, 1933.

**INTERLOCKING DIRECTORS: BANCAMERICA-BLAIR CORPORATION,  
SINCLAIR CONSOLIDATED OIL CORPORATION AND PETROLEUM  
CORPORATION OF AMERICA—Continued**

John Markham.....	Petroleum Corporation...	President, 1929, 1930, 1931, 1932, 1933.
		Board of Directors, 1929, 1930, 1931, 1932, 1933.
	Sinclair.....	Board of Directors, 1932.
	Prairie Oil & Gas.....	Board of Directors, 1931.
	Prairie Pipe.....	Board of Directors, 1930, 1931.
Henry Lockhart, Jr.	Bancamerica-Blair.....	Board of Directors, 1930, 1931.
	Prairie Pipe.....	Board of Directors, 1931.
H. H. Rogers.....	Petroleum Corporation...	Board of Directors, 1929, 1930, 1931, 1932, 1933.
	Sinclair.....	Board of Directors, 1929, 1930, 1931, 1932, 1933.
R. E. Cutten.....	Petroleum Corporation...	Board of Directors, 1929, 1930, 1931, 1932, 1933.



## Appendix F

SUMMARY OF PURCHASES AND SALES OF GENERAL INVESTMENT CORPORATION (FORMERLY THE PUBLIC UTILITY HOLDING CORPORATION OF AMERICA) PREFERRED STOCK BY GEORGE E. DEVENDORF AND FAMILY <sup>a</sup>

Purchases				Sales				Net profit				Balance based on—		
Date	Average price	Shares	Cost	Date	Average price	Shares	Proceeds	Average cost	Based on average cost	Recorder by seller	Shares	Average cost per share	Amount	Net outlay
1930														
Sept. 30	\$60.00	3 <sup>3</sup> / <sub>4</sub>	\$224.94								3 <sup>3</sup> / <sub>4</sub>	\$60.00	\$224.94	\$224.94
Aug. 12, 1932, to Mar. 9, 1934	6.065	14,295	86,636.75	1931 Apr. 16 to July 19	12.48	14,298 <sup>3</sup> / <sub>4</sub>	\$178,355.75	\$86,921.69	\$91,434.04	\$91,434.04	$\left\{ \begin{array}{l} 14,298^{3} \text{ } \frac{3}{4} \\ 0 \end{array} \right\}$ 2,460		86,921.69 0 49,377.50	86,921.69 (91,434.04) (42,056.54)
1935				1935 Apr. 5 to Nov. 14	34.35	6,246	81,507.60	19,377.50	35,130.10	35,130.10	0		0	(126,564.14)
Mar. 25 to June 25	20.07	2,460	49,377.50								17		478.55	(126,085.59)
May 23	28.15	17	478.55								392		10,978.55	(115,585.59)
June 19	28.00	375	10,500.00	June 19	29.45	6,392	11,543.72	10,978.55	565.17	565.17	0		0	(127,129.31)
Sept. 5	20.00	300	5,975.00								300		5,975.00	(121,154.31)
Sept. 5-6	15.00	6,500	52,500.00								3,800		58,475.00	(68,654.31)
Oct. 5 to Nov. 4	20.00	3,363 <sup>1</sup> / <sub>2</sub>	67,275.00								7,163 <sup>1</sup> / <sub>2</sub>		125,750.00	(1,379.31)
November	20.00	6,296 <sup>1</sup> / <sub>2</sub>	125,930.00								13,460		251,680.00	124,550.69
Dec. 18	36.00	440	15,840.00								13,900	19.2387	267,520.00	140,390.69
1936				1936 Aug. 20	60.00	800	48,000.00	15,390.96	32,609.04	32,609.04	13,100		252,129.04	92,390.69
				Aug. 20	60.00	2,500	150,000.00	48,096.75	101,903.25	101,903.25	10,600		204,032.29	(57,609.31)
				Aug. 20-21	30.00	1,600	95,964.00	30,881.92	65,082.08	65,082.08	9,000		173,150.37	(153,573.31)



## Appendix G

### BRIEF DESCRIPTION OF ORGANIZATION AND CONTROL OF THE ASSOCIATED GAS & ELECTRIC SYSTEM

#### ORGANIZATION AND CONTROL OF ASSOCIATED GAS AND ELECTRIC COMPANY

Associated Gas and Electric Company was incorporated under the laws of the State of New York on March 19, 1906, with three subscribers to its capital stock, Messrs. Treman, Summers, and Morris, all of Ithaca, New York. These individuals transferred to the Associated Gas and Electric Company control of certain gas and electric companies located chiefly in the central part of New York State in consideration for the issuance to these individuals of \$1,200,000 of the capital securities of Associated Gas and Electric Company.<sup>1</sup>

Associated Gas and Electric Company was controlled until March 1922 by J. G. White & Company, Inc., and Montgomery Clothier & Tyler (later Montgomery & Company), Philadelphia bankers, the majority of the control stock being held by J. G. White & Company, Inc.<sup>2</sup>

J. I. Mange, who was an electrical engineer employed by Mr. White, president of J. G. White & Company, Inc., became vice president of J. G. White Management Corporation;<sup>3</sup> and in 1912 Mr. Mange became vice president and general manager of Associated Gas and Electric Company.<sup>4</sup> H. C. Hopson, who had had experience with regulatory agencies in Washington, D. C., and Wisconsin, was head of the Capitalization Division of the New York Public Service Commission in 1913 when he met Mr. Mange. The New York Public Service Commission had jurisdiction over the utility companies which Mr. Mange was then operating; and, as Mr. Mange described it, "I had to go before him (Mr. Hopson) for a lot of things that I needed."<sup>5</sup>

Mr. Hopson, who was an accountant and lawyer with what Mr. Mange describes as "special qualifications in the field of finance," left the employ of New York Public Service Commission in 1915 or 1916 and opened an office to handle "Commission matters," "rate matters," "tax matters, and so on." Mr. Mange promptly employed Mr. Hopson's services.<sup>6</sup>

<sup>1</sup> Report of the Federal Trade Commission Report on Utility Corporations, 1932 (Senate Doc. No. 92, 70th Cong.), Part 45, pp. 992-4.

<sup>2</sup> Id., at 995.

<sup>3</sup> *In the Matter of Associated Gas and Electric Corporation* File 2-3024-5, an Investigation under Section 8 (e) of the Securities Act of 1933, before the Securities and Exchange Commission, pp. 329-367.

<sup>4</sup> Id., at 330-1.

<sup>5</sup> Id., at 363-71, 407.

<sup>6</sup> Id., at 363-71.

## ACQUISITION OF CONTROL OF ASSOCIATED GAS AND ELECTRIC COMPANY BY HOPSON AND MANGE

In March 1922, J. I. Mange and H. C. Hopson, "on a fifty-fifty basis," bought control of Associated Gas and Electric Company<sup>7</sup> with funds which they borrowed from New York banks without any collateral. Hopson and Mange repaid these loans several years later. Hopson and Mange became directors of Associated Gas and Electric Company on March 14, 1922. Mr. Mange also became president of the company and continued to direct its operations, although for a number of years he retained his vice presidency of J. G. White Management Corporation. Mr. Hopson also became treasurer of the Associated Gas and Electric Company and continued to supervise all the company's financial, rate, legal, and tax matters as he had previously done.<sup>8</sup>

Mr. Mange testified as follows concerning Mr. Hopson's duties after he became treasurer:<sup>9</sup>

Q. What did he do?

\* \* \* \* \*

A. Well, he didn't do anything that he wasn't doing already. He was handling the financial end of the Associated at that time, and the rate end.

Q. He was already handling it?

A. We had the same kind of an arrangement with him that we have now, and he has been for years working with me on it.

Q. You mean that he is still today acting as financial——

A. Exactly as he was then.

Q. Financial consultant on the Associated Gas and Electric?

A. And tax consultant.

Q. Accounting and financial and taxes?

A. Yes, sir.

\* \* \* \* \*

Q. And you continued to direct the operating and management affairs of the company?

A. Yes, sir.

Q. And Mr. Hopson, his duties were what?

A. He become the treasurer, and handled all financial matters, and rate and legal matters, and tax matters.

Q. And he continued as an officer of the company, up through to when?

A. He continued as treasurer, and then he became vice president and treasurer, about five years ago he resigned as an officer of the company, and a director.

Q. What position does he occupy now, in relation to the Associated Gas and Electric Company?

A. He doesn't occupy any except as an employee.

Q. As an employee?

A. He still controls or still does the tax matters and the rate matters, and such other matters concerning those things.

<sup>7</sup> *Id.*, at 995-6, and Hearings before the Committee on Interstate and Foreign Commerce, House of Representatives, In re: Public Utility Holding Companies (H. R. 5423, 74th Cong.), Part 2, pp. 1473-6.

<sup>8</sup> *Ibid.*, and Report of the Federal Trade Commission on Utility Corporations, Part 45, p. 996.

<sup>9</sup> In the matter of Associated Gas and Electric Corporation before the Securities and Exchange Commission, *op. cit. supra*, note 3, at 367-8, 371.

Q. He is an employee of the Associated Gas and Electric Company?

A. Of all of the companies; of the System.

Q. And essentially he performs the same duties that he has in the past?

A. Always the same.

### COST AND METHOD OF ACQUIRING CONTROL

Although Associated Gas and Electric Company had total assets at the time of approximately \$4,600,000, Messrs. Hopson and Mange were able to purchase control of the company with \$298,318.19 of borrowed money.<sup>10</sup> Mr. Hopson and Mr. Mange used two companies which they organized, Associated Utilities Corporation and Public Utility Investing Corporation, to effect the transaction of acquiring control of Associated Gas and Electric Company. Associated Utilities Corporation in March 1922 acquired, principally from J. G. White & Company, Inc., of New York and Montgomery & Company of Philadelphia, 5,979 shares of the \$100 par common stock of Associated Gas and Electric Company (the company's only voting stock) for \$292,060 or about \$48 a share. As part of the transaction, Associated Utilities Corporation apparently borrowed at least \$71,748 from Public Utility Investing Corporation, which apparently had borrowed these funds from banks. This transaction gave Hopson and Mange control of Associated Gas and Electric Company.<sup>11</sup> Subsequently they acquired, through a third company which they organized (Associated Securities Corporation) the remaining 21 shares of outstanding common stock for \$6,258.19 including expenses.<sup>12</sup>

However, for some reason, Messrs. Hopson and Mange did not continue to hold their control of Associated Gas and Electric Company through Associated Utilities Corporation but had the control stock transferred to Associated Securities Corporation which they formed in November 1922. Messrs. Hopson and Mange paid into Associated Securities Corporation \$1,000 in cash and received therefor ten shares of the capital stock of that corporation. In addition, they turned over to Associated Securities Corporation an option to buy from Associated Utilities Corporation its holdings of 5,979 shares of common stock of Associated Gas and Electric Company at \$12.50 per share. For this option, Associated Securities Corporation issued to Mr. Hopson and Mr. Mange 990 shares of no-par common stock with a stated value of \$99,000. The option was set up as an asset on the books of Associated Securities Corporation at \$99,000 as part of the cost of the Associated Gas and Electric Company common stock which it subse-

<sup>10</sup> Utility Hearings before the Committee on Interstate and Foreign Commerce, op. cit. supra, note 7, pp. 1473 and 1475. See also Report of the Federal Trade Commission on Utility Corporations, Part 45, p. 1458. But compare *In the Matter of Associated Gas and Electric Corporation*, before the Securities and Exchange Commission, op. cit. supra, note 3, at 437, where in 1937 Mr. Mange testified:

\* \* \* \* \*

Q. How much of that amount did you put up, out of your own pocket, and how much did you borrow?

A. I couldn't tell you that now.

<sup>11</sup> Utility Hearings before the Committee on Interstate and Foreign Commerce, op. cit. supra, note 7, p. 1474.

<sup>12</sup> Ibid. See also Report of the Federal Trade Commission on Utility Corporations, Part 45, p. 1000.

quently acquired through the exercise of the option. Associated Securities Corporation had borrowed \$71,748 from Public Utility Investing Corporation for the purpose of exercising the option. As has been indicated, Associated Securities Corporation also acquired the remaining outstanding 21 shares of Associated Gas and Electric Company common stock, paying therefor \$6,258.19, including expenses.

### CONTROL HELD THROUGH TRUSTS

In this manner, Messrs. Hopson and Mange placed the control of Associated Gas and Electric Company<sup>13</sup> in Associated Securities Corporation. Control of Associated Securities Corporation in turn was then placed in Associated Gas & Electric Properties<sup>14</sup>—a Massachusetts trust—which Hopson and Mange had formed June 1, 1924, under the name of Associated Gas and Electric Companies. The sum of \$10,000 and the entire 1,000 shares of common stock of Associated Securities Corporation were transferred to Associated Gas & Electric Properties which carried these 1,000 shares of Associated Securities Corporation common stock on its books at \$90,000. The total capitalization of Associated Gas & Electric Properties was therefore \$100,000, for which two equal shares of beneficial interest in the Trust were issued—one to Hopson and one to Mange.<sup>15</sup> As a consequence, Messrs. Hopson and Mange, with an investment of \$298,318.19, controlled Associated Gas & Electric Properties, which controlled Associated Securities Corporation, which in turn controlled the entire Associated Gas & Electric System, with total assets at that time of approximately \$4,600,000. The return which Associated Gas & Electric Properties received on this investment was comparatively large and was sufficient to pay back within several years the entire amount of the initial investment.<sup>16</sup>

The beneficial ownership of Mr. Mange's share of the Massachusetts trust, Associated Gas & Electric Properties, was placed in his and his wife's personal holding company, Managing and Investing, Incorporated, all the stock of which has been held and owned by his wife and children.<sup>17</sup>

<sup>13</sup> After June 1925, Associated Gas and Electric Company controlled Eastern Utilities Investing Corporation. See Report of Federal Trade Commission on Utility Corporations, Part 45, and Public Examination, Eastern Utilities Investing Corporation, at 23279.

<sup>14</sup> Public Examination, Eastern Utilities Investing Corporation, at 23279, 23321.

<sup>15</sup> Utility Hearings before the Committee on Interstate and Foreign Commerce, op. cit. supra, note 7, pp. 1474-5. See also Report of the Federal Trade Commission on Utility Corporations, Part 45, pp. 995-1005.

<sup>16</sup> Id., at 1475.

<sup>17</sup> See *infra*, and *In the Matter of Associated Gas and Electric Corporation* before the Securities and Exchange Commission, op. cit. supra, note 3, at 372-6 (Mr. Mange on the witness stand):

Mr. TRAVIS (Counsel for Associated Gas and Electric Corporation. I will read this statement, Mr. Mange, which was prepared in my office, and then you can state whether or not it is correct [reading]: "Managing and Investing, Incorporated, is a Delaware corporation which owns various securities of other corporations. Prior to February 10, 1934, all of the stock of Managing and Investing, Incorporated, was owned by Lydia P. Mange, who died on that date, a resident of Nassau County, New York. The decedent, Lydia P. Mange, left a will bequeathing her entire residuary estate to John I. Mange. By an instrument in writing duly executed, filed, and recorded, John I. Mange renounced the residuary legacy under the decedent's will. There resulted an intestacy as to the residuary estate of the decedent, and this was distributable, under the laws of the State of New York, one-third to John I. Mange as surviving spouse, and two-thirds to the surviving children of the

So, too, the beneficial interest in Mr. Hopson's share of Associated Gas & Electric Properties has been placed in his family.<sup>18</sup>

However, Daniel H. Starch, Hopson's brother-in-law, stated that the purpose of Associated Gas & Electric Properties was to have the

decendent. There were four children so surviving, Winthrop E., Emerson W., John P., and Lydia. John I. Mange assigned to Oak Ridge Farms, Inc., his one-third distributive share of the residuary estate in payment of an antecedent indebtedness. This assignment was made by an instrument in writing duly filed and recorded. After debts and taxes of the estate were paid, the estate was distributed.

"Each of the four children received 328 shares of stock of Managing and Investing, Incorporated, and the outstanding balance of 58 shares, together with various other assets of the estate, were received by Oak Ridge Farms, Inc., the assignee of John I. Mange. Oak Ridge Farms, Inc., transferred the 58 shares of Managing and Investing, Incorporated, together with various other property, to Managing and Investing, Incorporated, in payment on account of indebtedness owing to the latter. All of the outstanding stock of Managing and Investing, Incorporated, was thereupon owned by the four surviving children of Lydia P. Mange, deceased.

"By deed of trust dated October 31, 1936, Winthrop E. Mange, Emerson W. Mange, John P. Mange, and Lydia Mange Parent, the surviving children, transferred their stock of Managing and Investing, Incorporated, to Winthrop E. Mange, as trustee; and Winthrop E. Mange, as trustee, is now and has been, ever since the making of the trust, the sole stockholder of Managing and Investing, Incorporated. Helen Deniston Mange is the life beneficiary of the trust, and on her death the trust estate is distributable to the settlers.

"The one-half beneficial interest in Trustees Under Declaration of Trust Dated June 1, 1924, [formerly known as Associated Gas & Electric Properties] continues to be one of the assets of Managing and Investing, Incorporated."

By Mr. BROOKHART:

Q. Do you understand the facts in the statement as read to be true?

A. Yes, sir.

N. B. Apparently the aforementioned Managing and Investing, Incorporated, is a different company from Managing and Investing, Inc., which prior to July 1927 was an investing company owned by Mr. Mange and his family, but from July 1927 to the spring of 1928 was a subsidiary of Associated Gas and Electric Company, with assets consisting almost solely of contracts to service subsidiaries of Associated Gas and Electric Company. (See Sec. XI, D, 9, c, supra, *Investment in Managing and Investing, Inc.*)

<sup>18</sup> In the Matter of Utilities Employees Securities Company, before the Securities and Exchange Commission, Docket No. 31-419-1, Volume 2, Exhibit 84 reads with respect to the ownership of this trust on October 18, 1938, as follows: "There are two certificates of beneficial interest in Trustees Under Declaration of Trust dated June 1, 1924. One is owned by Managing and Investing, Incorporated, and is registered in the n/o J. I. Mange as nominee \* \* \*. The stock of Managing and Investing, Incorporated, is held in a Trust created pursuant to Deed of Trust dated October 31, 1936, of which Helen D. Mange [the wife of J. I. Mange] is beneficiary.

The other certificate is owned by Trustees Under Declaration of Trust dated July 27, 1935, and is registered in the n/o H. C. Hopson, as nominee. The beneficial and record owner of the stock of Trustees Under Declaration of Trust dated July 27, 1935, is Tarleton Securities Company. The nonvoting stock of Tarleton Securities Company is owned by A. H. Starch, N. H. Jones, and P. M. Hopson [all sisters of H. C. Hopson]. The voting stock of Tarleton Securities Company is owned by T. W. Moffat and Percy H. Wilson, Trustees for Claire and Malcolm Jones [evidently niece and nephew of H. C. Hopson]."

See also *In the Matter of Associated Gas and Electric Corporation* before the Securities and Exchange Commission, op. cit. supra, note 3, at 377-80 and testimony of Daniel H. Starch, a brother-in-law of H. C. Hopson (see id., at 439-40) who testified as follows (id., at 377-80 and 506-7):

Q. And who were those shares issued to?

A. They were issued to, at that time, to Mrs. Starch and to her two sisters.

Q. Who are her sisters, the names please, for the record?

A. Mrs. Norma H. Jones, and the other one is Miss Pearl Hopson.

Q. Were those all of the shares that were issued, three shares?

A. I think so.

Q. If I understand it correctly, this trust was formed some time in 1935 and three shares were issued under it, namely, to Amy H. Starch—that is your wife—and Norma H. Jones, and Pearl Hopson, is that right?

A. Yes, sir.

Q. And these three beneficiaries are all sisters of Mr. Hopson, who has been the previous owner of the beneficial one-half interest of June 1, 1924, trust, which have been transferred to this trust of some time in 1935, is that correct?

A. Whether it was held continuously prior to that time, I don't know.

He further testified (id., at 511):

Q. What was the purpose for forming this trust?

A. Why, I presume simply to hold the interest, the half interest in the 1924 trust, for the three sisters of Mr. Hopson.

shares in the Associated Gas and Electric Company "held together so that neither interest could be sold without the consent of the other."<sup>19</sup> Mr. Mange testified in May 1937 that he still had his own share and that he had not given Mr. Hopson permission to dispose of his share. As of October 18, 1938, the two certificates were still controlled and owned by Mr. Hopson, Mr. Mange, and their families.<sup>20</sup>

### CONTROL OF SERVICE COMPANIES

Aside from operating and construction services which were rendered to the "System" by subsidiaries of Associated Gas and Electric Company, other services such as legal, tax, accounting and financial services were rendered to the "System," at first by H. C. Hopson personally and later by H. C. Hopson and Company and other companies which he organized and controlled.<sup>21</sup>

From 1925 to 1932 all tax, accounting, and financial services were performed by H. C. Hopson and Company, a partnership. Although some of the tax services may still be performed by H. C. Hopson and Company,<sup>22</sup> most of the personnel and business activities of H. C. Hopson and Company were taken over about the beginning of 1932 by the following organizations:

(a) *Utility and Financial Accountants, Inc.*, organized under the laws of Delaware about January 1, 1932.<sup>23</sup> This corporation was succeeded by Utilities and Financial Accountants, a New Jersey common-law trust formed in 1936,<sup>24</sup> except that certain employees of Utility and Financial Accountants, Inc.,<sup>25</sup> who were engaged in keeping corporate records, were transferred to Corporate Records and Secretarial Assistants, a New Jersey common-law trust organized about September 1935<sup>26</sup> to carry on such work.

(b) *Financial and Securities Assistants*,<sup>27</sup> a New Jersey common-law trust organized in 1932,<sup>28</sup> which in turn was succeeded by Finance and Securities Assistants, a New Jersey trust organized about the beginning of 1937.<sup>29</sup>

(c) *Transfer and Coupon Paying Agency*, an organization created in 1931 or 1932,<sup>30</sup> largely to take care of transfers of securities, paying interest coupons and keeping records.<sup>31</sup> This agency succeeded to the work formerly done by H. C. Hopson and Company through the medium of F. E. Taylor and W. L. Freund, employees who acted as transfer agents,<sup>32</sup> in turn being succeeded by

<sup>19</sup> Id., at 577.

<sup>20</sup> *In the Matter of Associated Gas and Electric Corporation* before the Securities and Exchange Commission, op. cit. supra, note 3, pp. 377-80; see stipulation quoted in note 18, supra.

<sup>21</sup> *In the Matter of Associated Gas and Electric Corporation* before the Securities and Exchange Commission, op. cit. supra, note 3, pp. 596 and 603. J. H. Shinn, who acted as director, trustee, or executive officer of Hopson service companies, testified (id., at 589):

Q. Was it generally understood that Mr. Hopson was the boss of the organization at the time that you became first associated with H. C. Hopson and Company?

A. Yes; I think that that is true.

<sup>22</sup> Id., at 600-1.

<sup>23</sup> Id., at 591.

<sup>24</sup> Id., at 590-1.

<sup>25</sup> Id., at 595.

<sup>26</sup> Id., at 594.

<sup>27</sup> Id., at 601.

<sup>28</sup> Id., at 603.

<sup>29</sup> Id., at 602.

<sup>30</sup> Id., at 605.

<sup>31</sup> Id., at 606.

<sup>32</sup> Id., at 607.



Transfer and Paying Agency, a New Jersey Trust, organized about the beginning of 1937.<sup>33</sup>

(d) *Utilities Accountants and Tax Consultants*, a New Jersey trust organized in 1931,<sup>34</sup> which held the contracts to perform services for various companies in the Associated Gas & Electric System.<sup>35</sup> These services, however, have been actually performed by Utilities and Financial Accountants, and its predecessor, Utility and Financial Accountants, Inc.<sup>36</sup> Utilities Accountants and Tax Consultants, apparently, has not been succeeded by any company of similar name but an organization has been formed under the name of Utility Accountants and Tax Consultants<sup>37</sup> and some of the service employees who formerly received salaries from Utilities Accountants and Tax Consultants now receive them from Public Utility Investing Corporation.<sup>38</sup>

### GROWTH OF ASSOCIATED GAS AND ELECTRIC COMPANY

Associated Gas and Electric Company did not experience any unusual increase in size in the period between the time of its organization and the time when H. C. Hopson and J. I. Mange acquired control 16 years later. In those first 16 years, 1906–1921, the consolidated total assets of the Associated Gas and Electric Company and its subsidiaries increased from about \$1,200,000<sup>39</sup> to \$6,942,570 as at December 31, 1921.<sup>40</sup> In the next four years, however, or during the early control period of Mr. Hopson and Mr. Mange, the consolidated total assets increased to \$209,601,178 as of December 31, 1925,<sup>41</sup> the end of the year during which Pennsylvania Electric Corporation (subsequently named Eastern Utilities Investing Corporation) was acquired. By the end of 1931, the consolidated total assets of Associated Gas and Electric Company had, according to its books, increased to \$941,238,518.32.<sup>42</sup> By December 31, 1937, Associated Gas and Electric Company reported its consolidated total assets at \$1,037,832,677.21.<sup>43</sup> This rapid growth was accelerated chiefly through the issuance and sale or exchange of large amounts of additional securities.<sup>44</sup>

<sup>33</sup> Id., at 606.

<sup>34</sup> Id., at 608.

<sup>35</sup> Id., at 609–10.

<sup>36</sup> Id., at 611–12.

<sup>37</sup> Id., at 619–20; see also Mr. Stix's testimony, op. cit. supra, note 14, at 27020.

<sup>38</sup> See Mr. Stix's testimony, op. cit. supra, note 14, at 27022.

<sup>39</sup> Federal Trade Commission Report on Utility Corporations, Part 45, p. 1456.

<sup>40</sup> Id., at 1464.

<sup>41</sup> See note 42 following.

<sup>42</sup> Op. cit. supra, note 14, Commission's Exhibit No. 3775 also sets forth on a comparative basis Associated Gas and Electric Company's total assets at year-ends, as follows:

1923-----	\$16, 884, 669. 54	1930-----	\$922, 008, 793. 55
1924-----	62, 257, 097. 01	1931-----	941, 238, 518. 32
1925-----	209, 601, 177. 87	1932-----	867, 722, 379. 82
1926-----	255, 161, 569. 64	1933-----	959, 277, 378. 83
1927-----	312, 701, 682. 17	1934-----	844, 743, 778. 22
1928-----	318, 514, 494. 26	1935-----	1, 016, 705, 070. 89
1929-----	900, 491, 542. 90		

The figures for the years 1927, 1928, 1929, and 1936 do not include General Gas & Electric Corporation nor Eastern Utilities Investing Corporation.

<sup>43</sup> Securities and Exchange Commission File No. 30–127, Exhibit D (Registration Statement of Associated Gas and Electric Company under the Public Utility Holding Company Act of 1935).

<sup>44</sup> Report of the Federal Trade Commission on Utility Corporations, Part 45, pp. 1466–7.

**SIGNIFICANCE OF ACQUISITION OF EASTERN UTILITIES INVESTING CORPORATION<sup>45</sup>**

Until 1922, or prior to the time that Messrs. Hopson and Mange became the dominating personalities in the Associated Gas and Electric Company, that company had acquired the control of only one additional utility operating company, namely, Kentucky Public Service Company. However, soon after Messrs. Hopson and Mange came into control, the program of expanding the Associated Gas & Electric System by acquiring other companies was undertaken. In 1923 certain properties in New England were acquired; in 1924 control of Staten Island Edison Corporation and other operating companies in the State of New York was obtained; and in 1925 Manila Electric Company and Long Island Water Corporation were acquired.<sup>46</sup> Thus, up to the middle of 1925, the company, under the dominance of Messrs. Hopson and Mange, controlled subsidiaries operating in New England, New York, Ohio, Kentucky, and the Philippine Islands.

In September 1925 Associated Gas and Electric Company acquired control of Pennsylvania Electric Corporation (subsequently Eastern Utilities Investing Corporation). The purchase of control of Eastern Utilities Investing Corporation added to the "System" certain gas and electric operating properties located in the western part of Pennsylvania and the northwestern part of Maryland.

The magnitude and importance of this acquisition to Associated Gas and Electric Company is indicated by the fact that the approximately \$126,000,000 of total consolidated assets of Associated Gas and Electric Company were increased by at least 72% through the acquisition of the Eastern Utilities Investing Corporation, whose consolidated assets as at December 31, 1925, were reported to be \$91,160,676.<sup>47</sup> Similarly, the consolidated income statements<sup>48</sup> indicate that the gross revenues of Associated Gas and Electric Company on a consolidated basis were more than doubled by its acquisition of the Eastern Utilities Investing Corporation.

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<sup>45</sup> Id., at 993-6.

<sup>46</sup> Id., at 1017.

<sup>47</sup> Op. cit. supra, note 14, Commission's Exhibit No. 3815, annual report of Pennsylvania Electric Corporation for the year 1925. The total consolidated assets of Associated Gas and Electric Company as at December 31, 1925, according to the annual report for that year, excluding the total assets of Eastern Utilities Investing Corporation (then called Pennsylvania Electric Corporation), amounted to \$126,227,756, which included the total assets of Manila Electric Company and Long Island Water Corporation acquired during that year. Consequently, with the acquisition of Eastern Utilities Investing Corporation, Associated Gas and Electric Company's total consolidated assets were increased by more than 72%.

<sup>48</sup> Annual report of Associated Gas and Electric Company for the year 1925 as reproduced in the Report of the Federal Trade Commission on Utility Corporations, Part 45, p. 1586 and annual report of Pennsylvania Electric Corporation for the year ending December 31, 1925, op. cit. supra, note 14, Commission's Exhibit No. 3815.

## Appendix H

### SCHEDULE OF OWNERSHIP OF VOTING STOCK OF EASTERN UTILITIES INVESTING CORPORATION FROM JUNE 1925 TO SEPTEMBER 1935

(This schedule is reproduced from Item 5 of Commission's Exhibit No. 3772 in the Public Examination of Eastern Utilities Investing Corporation, as prepared by Associated Gas & Electric System and verified by counsel for that System and for Eastern Utilities Investing Corporation. Indentations in the names of companies indicate that the company whose name is indented is a 100% subsidiary of the company whose name appears immediately above it.)

	Shares	Cost
<i>June 1925:</i> Associated Gas & Electric Properties. Associated Securities Corporation. Associated Gas & Electric Co. Date acquired June 1925.....	114,610.68 common stock.	\$11,461,068.00
<i>December 1926:</i> Associated Gas & Electric Properties. Associated Securities Corporation. Associated Public Utilities Securities Corporation. Date acquired December 1926.....	171,754.48 common stock.	17,633,387.73
<i>July 1927:</i> Associated Gas & Electric Properties. Associated Securities Corporation. Associated Gas & Electric Co. Associated Gas & Electric Securities Co., Inc. Date acquired, July 1927.....	100,000 (class B)....	100,000.00
<i>November 1927 (as of August 1927):</i> Associated Gas & Electric Properties. Eastern Utilities Investing Trust. Date acquired August 1927.....	100,000.....	100,000.00
<i>March 1932:</i> Associated Gas & Electric Properties. Associated Securities Corporation. Associated Gas & Electric Co. Associated Gas & Electric Corporation. Date acquired, March 1932.....	500,000.....	2,100,000.00
<i>October 1932:</i> Associated Gas & Electric Properties. Associated Securities Corporation. Associated Gas & Electric Co. Eastern Utilities Securities Corporation. Date acquired, October 1932.....	500,000.....	2,100,000.00
<i>September 1935:</i> **Associated Gas & Electric Properties (name changed 8/9/34 to Trustees Under Declaration of Trust dated June 1, 1924). **Voting Trustees under Voting Trust Agreement dated Mar. 27, 1933, for stock of Associated Gas & Electric Co. Associated Gas & Electric Co. Date acquired, September 1935.....	50,000.....	25,000.00

In October 1936 Eastern Utilities Investing Corporation filed a petition in the U. S. District Court for the District of Delaware, under Section 77B of the Bankruptcy Act as amended.

\*\*Reference is made to registration statement of Metropolitan Edison Co. for data as to the voting power held by the trustees (registration statement No. 2-1747).



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